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TAX POLICY

Effects of Changing the Tax Treatment of Fringe Benefits

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The Honorable Lloyd Bentsen, Chairman
The Honorable Dan Rostenkowski, Vice Chairman
Joint Committee on Taxation
Congress of the United States

This report discusses employee benefit tax policy issues as they relate to four of the more common employer-provided fringe benefits—pensions, health and life insurance, and flexible benefits. For each of these benefits, the report discusses (1) historical and legislative background information, (2) data on employers who provide and employees who are covered by these benefits, (3) estimated tax expenditure data, and (4) implications of taxing these benefits.

This report was prepared, not at your request, but pursuant to GAO's basic statutory authority. We undertook this effort to assist Congress in its consideration of options for reducing the federal budget deficit and improving tax equity.

We are also sending copies of this report to the Secretary of the Treasury, the Director of the Office of Management and Budget, and appropriate congressional committees and members of Congress.

Major contributors to this report are listed in appendix II. If you have questions, please call me on (202) 275-6407.

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Executive Summary

Purpose

This year the Department of the Treasury is expected to forgo about $91 billion in tax revenues because employer-provided fringe benefits are excluded from taxable income. The size of these tax expenditures as well as the uneven coverage of employer-provided fringe benefits across the workforce have prompted proposals to change their tax treatment in an effort to either (1) restrict the extent of subsidized benefits to reduce the deficit or lower income tax rates or (2) expand benefit coverage.

Before attempts are made to change the current tax treatment, GAO believes that an evaluation of the current system of fringe benefit tax subsidies would be beneficial. For this review, GAO focused on (1) the history and background of the tax-preferred status of these benefits, (2) the percentage of workers receiving benefits and the types of benefits received, (3) estimated taxes forgone for these benefits, and (4) how changes in employee benefits tax policy might affect tax equity among different groups and the level of benefits provided. This report describes selected fringe benefits and contains statistical information about employers who provide them and employees who receive them. In this report, GAO also discusses implications of changing the tax treatment of fringe benefits, focusing particularly on some representative types of proposals that proponents say will achieve particular equity and efficiency goals. However, GAO does not take a position on whether changes in fringe benefit tax policies should be adopted.

Background

The Internal Revenue Act, as amended, and Internal Revenue Service rulings have generally resulted in favorable tax treatment for the fringe benefits GAO reviewed—pension, health and life insurance, and flexible benefits. Flexible benefit plans allow employees to choose the benefits they prefer from a list of taxable and nontaxable fringe benefits offered by employers.

Employees benefit from the tax treatment of fringe benefits. The value of fringe benefits currently received by employees is generally not included as a part of an employee's taxable income. Employers also benefit because they provide their employees with more after-tax compensation at the same cost.

Results in Brief

Except for pensions, fringe benefit tax policy has not fundamentally changed in over a decade. However, estimated tax expenditures—revenues forgone as a result of preferential provisions—for the benefits GAO reviewed have increased significantly, from about $9 billion in 1975 (about 7.5 percent of individual income tax revenues) to over $91 billion in 1992 (about 17.3 percent of individual income tax revenues).

Large segments of our nation's working population receive employer-provided fringe benefits. In 1988, about 42 percent of the full-time, private-sector workers in the United States participated in pension plans, and in 1989, about 73 percent of all workers had employer-provided health benefits. Of employees who worked for employers with 100 or more employees, 90 percent were offered life insurance benefits and about 24 percent were eligible to participate in flexible benefit plans in 1989, an increase from 5 percent in 1986.

Current tax treatment of fringe benefits works against tax equity because some workers receive employer-provided, tax-preferred fringe benefits while others do not. In addition, because of this country's progressive tax rate structure, workers in higher tax brackets receive larger tax subsidies for these benefits than other workers. Further, some analysts believe that the tax preferences associated with employer-provided health benefits encourage employee "overspending" for health care.

Taxing fringe benefits could raise substantial revenue and improve tax equity. However, full taxation of these benefits could greatly increase employees' taxable incomes and, consequently, the income taxes they may have to pay. GAO's review of both fringe benefits and tax policy literature also indicated that the full taxation of pension and health benefits on a current-income basis could reduce coverage. If the current tax treatment were changed, coverage of low-wage workers is likely to be more responsive because high-wage workers would tend to purchase coverage even without a tax break. However, some of the revenue generated could be used to target benefits at lower income families.

Taxing pension benefits might increase or decrease national savings, but the net effect is difficult to predict. For example, savings could decrease if employers decided not to offer pension plans or if employees preferred current rather than deferred compensation and did not provide for additional savings. However, if the increased revenues from taxing pensions were used to reduce the deficit, the resulting increase in government savings could offset these decreases.

Alternatives to fully taxing fringe benefits include (1) imposing ceilings on the amount of tax-free benefits provided or (2) allowing credits against taxes paid rather than exclusions from taxable income. These alternatives would generally raise much less revenue than fully taxing fringe benefits but would result in some improvements in equity and less reduction in coverage because they hold lower income groups harmless.

GAO's Analysis

Pensions

The largest of all tax expenditures are for employer-provided pension plans. Estimated tax expenditures for pensions for fiscal year 1992 total over $50 billion. Fewer than half of the full-time workers in the United States participate in pension plans. Further, pension plan coverage is not evenly distributed throughout the workforce. Greater rates of plan participation exist among employees who work for larger employers, are union workers, earn higher wages or salaries, or work in the public sector or in certain industries such as manufacturing, communications, and utilities. (See pp. 31-41.)

Pensions receive less favorable tax treatment than the other fringe benefits GAO reviewed. Pension benefits earned by employees are not included in current taxable income; instead, taxes are deferred until employees receive their pensions. During the 1980s, Congress enacted a number of amendments to pension law in an effort to provide more employees with pension plan coverage and more equitable distribution of pension benefits among high- and low-paid workers. (See pp. 25-30.)

Improvements in equity between pension benefit recipients and nonrecipients could occur if pension benefits were taxed as they were earned. However, taxing pension benefits on a current-income basis could diminish pension coverage. A recent study suggested that coverage would decrease more for workers in low-wage industries than for workers in high-wage industries, who are more likely to receive pensions in the absence of tax considerations. Furthermore, taxing pensions at the individual level, as opposed to the pension fund level, could significantly increase the taxable incomes of older workers who earn larger benefits than younger workers because of the way benefits earned are determined. (See pp. 42-44.)

Increased tax revenues resulting from taxing pension benefits could be used, for example, to lower the federal deficit and increase public savings, expand public programs aimed at providing greater benefits to individuals, or lower general income tax rates. However, reductions in pension coverage could also reduce private savings if employers discontinued the plans they had previously funded and employees did not increase their savings for retirement. Because the magnitude of these potential effects is difficult to predict, the net effect on national savings is unknown. (See pp. 44-46.)

Health Benefits

About 73 percent of all U.S. workers had employer-provided health benefit coverage in 1989. Like employees with pension coverage, employees with health coverage are more likely to earn more, work for larger employers, belong to labor unions, and work for the government. In addition, over 40 percent of the nation's retirees have employer-provided health benefit coverage. Since 1975, estimated tax expenditures for employer-provided health benefits have increased from about $3.3 billion (2.7 percent of individual income tax revenues) to an estimated $33.5 billion in 1992 (6.3 percent of estimated individual income tax revenues). (See pp. 54-63.)

Since 1965, employers' cost for employee health benefits, as a percentage of total compensation, has doubled. As a result, employers are becoming increasingly concerned about their rising health benefit costs and retiree health obligations. Many employers are requiring their employees and retirees to pay a larger share of their health costs through higher deductibles and coinsurance charges. Even so, wide disparities exist in the range of health benefits that employers provide to their employees. (See pp. 63-73.)

Economists and health care commentators generally agree that low employee contributions for health care benefits have led to some overuse and may have increased the cost of health care services and supplies. By requiring employees to include some portion of the costs of employer-provided health benefits in taxable income, proponents of taxing health benefits believe there would be stronger incentives to economize in the medical marketplace. Opponents point out the extreme difficulty of determining just when extensive coverage becomes excessive coverage and are concerned that taxation could discourage some individuals from obtaining insurance and thus from obtaining timely and appropriate medical care. (See pp. 71-76.)

Options for taxing health benefits have called for either limiting the amount of employers' contributions excluded from employees' taxable incomes or replacing the exclusion with a health insurance tax credit that all employees would receive. Both options would improve equity. The first would do so by taxing employers' health benefit contributions that exceeded specified limits; the second would do so by equalizing tax subsidies received by employees regardless of their income tax brackets. While equity improvements would occur, these proposals would probably result in reduced coverage, but primarily for high-wage workers. And the overall reductions would not be as great as those resulting from full taxation. Some proposals would reallocate revenues saved by limiting the tax subsidy to extend benefits to uninsured workers or families. (See pp. 76-77.)

Life Insurance

According to the Bureau of Labor Statistics, over 90 percent of all employees working for employers with 100 or more employees have group term life insurance coverage provided by their employers. For fiscal year 1992, estimated tax expenditures for this insurance are $2.9 billion. The tax preferences associated with employer-provided insurance are limited to the cost of life insurance with a face value of $50,000. Employees are required to include in taxable income the cost of insurance exceeding this amount. (See pp. 79-80.)

Because life insurance costs increase as an individual ages, older employees receive a larger tax subsidy than younger employees for that portion of the benefit that is excluded from income. Options to tax the cost of life insurance by either reducing the amount of life insurance that could be provided tax free or by including the costs of all life insurance in taxable income would affect older workers the most. Some employees would discontinue their life insurance coverage rather than pay increased taxes. If these employees died, they would leave their dependents without employer-provided life insurance benefits. (See pp. 85-87.)

Flexible Benefits

Between 1986 and 1989, the percentage of employees working for employers that offered flexible benefits and employed 100 or more people increased from 5 to 24 percent. Under a flexible benefits plan, employees are allowed to choose between taxed compensation such as cash or tax-preferred benefits such as medical benefits, dental care, or disability benefits.

For many of these plans, employees can choose not only from among the benefits offered but also can set aside pretax dollars in special accounts called flexible spending accounts. Employees can subsequently use the money placed in health care or child care accounts to pay medical or child care expenses. Estimated tax expenditures for flexible benefit plans for fiscal year 1992 total $3.5 billion, according to the Joint Committee on Taxation. (See p. 88.)

Many employers provide flexible benefits because it enables them to better control their benefit costs while enabling employees to select benefits that best meet their needs. In addition, employers do not have to pay payroll taxes on amounts that employees contribute to flexible spending accounts. (See p. 89.)

Partly because they are more like cash compensation, flexible benefit plans can help employees put together efficient benefit packages. For example, if spouses working for different employers were each offered health benefits, spouses who were offered health benefits as part of a flexible benefits plan could instead elect to receive other, nonhealth benefits. However, from an equity viewpoint, when compared to the other benefits GAO reviewed, only limited numbers of employees are covered by flexible benefit plans. As a result, employees who can make contributions to flexible spending accounts receive substantial tax preferences compared to those who must use after-tax dollars to purchase health or child care benefits. (See pp. 90-93.)

Tax Implications

If employees were taxed on the full value of the fringe benefits they received, substantial tax revenues could be raised. Full taxation of benefits would go a long way toward improving tax equity, particularly between benefit recipients and nonrecipients, but also among benefit recipients in different tax brackets. However, full taxation of benefits could reduce the demand for benefits and, in the absence of any offsetting government action, could eventually result in fewer benefits being provided, particularly to low-wage workers. With employers providing fewer benefits, pressures on governmental bodies to provide retirement income and health insurance protection could increase. Such government-provided benefits could possibly use up some or all of the revenues generated by eliminating these exclusions. (See pp. 99-101.)

Because of the consequences of full taxation, other options have been discussed to improve tax equity while retaining at least some of the tax

preferences. These options include taxing only those benefits that exceed specified limits (for example, health benefits in excess of $1,200 for individual coverage) or including the full value of benefits in taxable income but allowing a tax credit based on the value of benefits received. These options have the advantage of targeting the tax subsidy to those workers least able or inclined to purchase the benefits in the absence of a subsidy. In this case, as well as the case of full taxation, some of the revenues gained could be used to fund new or expand existing programs aimed at the uninsured. (See pp. 101-105.)

Recommendations

This report contains no recommendations.

Agency Comments

Due to the informational nature of this report, agency comments were not obtained.

Contents

Executive Summary		2
Chapter 1 Introduction		16
	Definition of Tax Expenditures	17
	Objectives, Scope, and Methodology	21
Chapter 2 Pensions—an Important Fringe Benefit That Is Not Available to All Employees		25
	Pension Plans Established to Provide Retirement Income to Employees	26
	Laws Grant Tax-Favored Status to Pension Plans, but Not Without Limitations	28
	Pension Coverage for Active Employees Varies by Worker Demographics	31
	Pension Coverage for Retired Workers Was Less Extensive	34
	Tax Expenditures for Pensions and Other Types of Retirement Income	40
	Implications of Changing Pension Benefit Tax Policy	42
	Burden and Equity Issues Affected by Taxation of Accrued Pension Benefits	46
	Cost to Administer Defined Benefit Pension Plans Could Have Detrimental Effects on Employers' Decisions to Maintain Plans	48
	Alternative Options Would Substitute Administrative Simplicity for Some Equity	50
	Summary	52
Chapter 3 Most Employees Receive Health Benefits From Employers, but Coverage and Cost-Sharing Disparities Exist		54
	Growth of Employer-Provided Health Benefits	55
	Legislative Provisions Affecting the Tax Treatment of Health Benefits	55
	Employer-Provided Health Benefits Are Widespread but Not Universal	57
	Coverage Varies by Industry Group	62
	Employer-Provided Health Coverage Less Extensive for Retirees	63
	Cost-Sharing and Coverage Disparities Exist Among Employers That Provide Coverage	66
	Tax Expenditures and Costs Related to Employer-Provided Health Benefits Are High	70

	Implications of Taxing Employer-Provided Health Benefits	71
	Summary	77
Chapter 4 Limitations on Tax Preferences Available for Employer-Provided Life Insurance Benefits		79
	Purpose and History of Employer-Provided Life Insurance Benefits	79
	Employer-Provided Life Insurance Widely Available but Face Value of Coverage Can Vary Substantially	82
	Some Equity Concerns Moderated by Limitations on Benefits	85
	Implications of Taxing Employer-Provided Life Insurance Benefits	85
	Summary	87
Chapter 5 Flexible Benefit Plans Allow Employees to Choose Among Selected Fringe Benefits		88
	Background and Early History of Flexible Benefits	89
	Legislative Background of Flexible Benefits	89
	Growth of Flexible Benefit Plans	90
	Tax Expenditures Related to Flexible Benefits	92
	Implications of Taxing Flexible Benefits	93
	Summary	94
Chapter 6 Implications of Changing Employee Benefit Tax Policy		95
	Including Fringe Benefits in Taxable Income Affects Older Workers and Those in Highest Tax Brackets the Most	96
	Full Taxation Would Result in Fewer Benefits Provided	99
	Alternative Methods of Taxing Benefits Could Have Less Effect on Coverage	101
	Conclusions	105
Appendixes	Appendix I: Information on Sources of Health Benefit Coverage for Individuals With Selected Demographic Characteristics	108
	Appendix II: Major Contributors to This Report	110
Related GAO Products		112

Tables

Table 1.1: Employee Benefits as a Percentage of Total Compensation, for Selected Years 17
Table 1.2: Selected Employee Benefit Tax Expenditures (Revenue Loss) and Tax Expenditures Relative to Individual Income Tax Revenues, for Selected Fiscal Years 19
Table 2.1: Percentage of Nonagricultural Wage and Salary Workers Covered and Participating in a Pension Plan, by Selected Industries (1988) 33
Table 2.2: Percentage of Nonagricultural Wage and Salary Employees Whose Employers Offered Pension Plan Coverage, by Age of Employee (1988) 33
Table 3.1: Percentage of Workers With No Health Insurance Coverage, by Industry of Primary Employment (1989) 63
Table 3.2: Estimated Tax Expenditures (Revenue Loss) for Employer-Provided Health Benefits, for Selected Years 70
Table 3.3: Health Care Expenditures as a Percentage of GNP 71
Table 4.1: Life Insurance Benefits by Type of Provider for Households With Insurance in 1984 81
Table 5.1: Flexible Benefits Offered by Private Employers That Responded to Benefit Surveys 91
Table 5.2: Participation in and Contributions to Flexible Spending Accounts by Employers Responding to Benefit Surveys 92
Table 6.1: Effects of Including Benefits in Hypothetical Employees' Taxable Incomes 97
Table 6.2: Differences in Pension Income Between Defined Benefit and Defined Contribution Plans for Hypothetical Employees 98
Table 6.3: Effects of Including Benefit Costs in Hypothetical Employees' Payroll Tax Bases 98
Table I.1: Percentage of Workers With Health Benefits, by Total Annual Earnings (1989) 108
Table I.2: Percentage of Workers With Health Benefits, by Age (1989) 108
Table I.3: Percentage of Workers With Health Benefits, by Marital Status (1989) 108
Table I.4: Percentage of Workers With Health Benefits, by Race (1989) 109

Figures

Figure 2.1: Percentage of Nonagricultural Wage and Salary Workers Participating in a Pension Plan, by Earnings (1988) 31

Figure 2.2: Percentage of Nonagricultural Private-Sector Wage and Salary Workers Whose Employers Offered Retirement Benefits, by Size of Employer (1988) 32

Figure 2.3: Retiree Households Receiving Pension Distributions, by Amount of Total Household Income in 1989 34

Figure 2.4: Replacement of Final Earnings by Pensions and Social Security Retirement Benefits for Participants With Selected Earnings Amounts (1989) 36

Figure 2.5: Percentage of Households With Retirees Receiving Pension Income, by Size of Pension Received (1989) 37

Figure 2.6: Pension Income as a Percentage of Total Income for Households Receiving Pensions (1989) 38

Figure 2.7: Household Receipt of Pension Income, by Race (1989) 39

Figure 2.8: Household Receipt of Pension Income, by Retiree Age (1989) 40

Figure 3.1: Percentage of Workers Under Age 65 Whose Employers Provided Health Benefits, by Size of Employer (1989) 58

Figure 3.2: Percentage of Workers With Employer-Provided Health Benefits, by Total Earnings (1989) 59

Figure 3.3: Percentage of Workers With Employer-Provided Health Benefits, by Age (1989) 60

Figure 3.4 Percentage of Employees With Employer-Provided Health Benefits, by Marital Status (1989) 61

Figure 3.5: Percentage of Employees With Employer-Provided Health Benefits, by Race (1989) 62

Figure 3.6: Health Care Coverage for Retirees Under Age 65 (1989) 64

Figure 3.7: Health Care Coverage for Retirees Over Age 64 (1989) 65

Figure 4.1: Percentage of Workers With Employer-Provided Life Insurance Based on Earnings and a Multiple-of-Earnings Factor 82

Figure 4.2: Percentage of Workers With Employer-Provided Life Insurance Benefits Based on Flat Dollar Amounts 83

Figure 4.3: Percentage of Workers With Employer-Provided Life Insurance Benefits, by Type of Insurance Offered 84

Abbreviations

ACLI	American Council of Life Insurance
AGI	adjusted gross income
BLS	Bureau of Labor Statistics
CBO	Congressional Budget Office
CPI	consumer price index
CPS	Current Population Survey
CRS	Congressional Research Service
EBRI	Employee Benefit Research Institute
ERISA	Employees Retirement Income Security Act of 1974
GNP	gross national product
HMO	health maintenance organization
IRA	individual retirement account
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation

Introduction

In addition to paying salaries or wages, most employers provide their employees nonwage compensation in the form of fringe benefits. Tax treatment of many of these benefits is advantageous to both employees and employers. Like salaries and wages, employers can usually deduct the cost of providing these benefits from their taxable incomes. However, unlike salaries and wages, the value or the costs of many fringe benefits are not included in employees' taxable incomes and are not subject to payroll taxes. Because of the tax-preferred nature of these benefits, employers can provide their employees with more after-tax compensation at the same cost or the same after-tax compensation at less cost.

Fringe benefits are forms of compensation paid for in whole or in part by the employer and in a form other than direct wages. Some benefits such as Social Security, Medicare, unemployment insurance, and workers' compensation insurance are required by law. Other benefits—vacation and sick days and rest periods—are discretionary and are fully taxable because they are included in an employee's wages or salary. Still other discretionary benefits, such as pensions, health and life insurance, and flexible benefits,[1] which are the subjects of this report, are not included in an employee's current taxable income. Taxes on pension benefits are usually deferred until employees receive these benefits after they retire.

Estimated fiscal year 1992 tax expenditures for the discretionary benefits we reviewed are expected to exceed $91 billion, according to Department of the Treasury and Joint Committee on Taxation sources. In return for these expenditures, our nation's employees receive benefits that contribute to their health and financial well-being. If these benefits did not receive a tax preference, employees might not want or employers might not provide the current level of benefits.

Congress has traditionally considered it to be desirable and in the public interest to have employers provide these benefits. If employers did not provide such benefits as pensions or health insurance to their workers, employees would have to provide for retirement or purchase health insurance on their own or bring pressure on governmental units to expand

[1]The terms "flexible benefits" and "cafeteria benefits" are often used interchangeably to describe plans or arrangements under which employees are given the opportunity to select from various types of benefits. For this report, we use the term flexible benefit plans to refer to these types of arrangements. We recognize that "qualified benefits" provided under a cafeteria plan as described in section 125 of the Internal Revenue Code are not as all-embracing as benefits that an employer could provide under a flexible benefits plan.

such programs as Social Security or Medicaid. Table 1.1 shows the growth of fringe benefits since 1950.

Table 1.1: Employee Benefits as a Percentage of Total Compensation, for Selected Years

Dollars in billions

	1950	1960	1970	1980	1989
Total compensation	$155	$297	$618	$1,638	$3,079
Employee benefits as a percent of total compensation					
Pensions	2.0%	2.8%	3.9%	5.8%	3.9%
Health insurance	.5	1.1	2.0	3.6	4.7
Life insurance	.3	.4	.5	.4	.4
Other benefits[a]	2.5	3.6	4.3	6.3	7.2
Total benefits	**5.3%**	**7.9%**	**10.7%**	**16.1%**	**16.2%**

[a]Other benefits include employers' share of Social Security and Medicare taxes, unemployment compensation, and workers' compensation insurance.

Sources: U.S. Chamber of Commerce and Employee Benefit Research Institute (EBRI) tabulations based on Surveys of Current Business, U.S. Department of Commerce.

Some observers, including some economists, question whether tax preferences related to fringe benefits continue to be warranted, particularly in view of (1) the large federal deficit, (2) the inequities created between those workers who receive all of their earnings in taxable wages and those who receive a substantial portion of their wages in nontaxable fringe benefits, and (3) the possibility that preferential tax treatment can lead to workers "overspending" on those activities granted tax-preferred status. In the past decade, the executive branch, congressional leaders, and some economists have called for comprehensive tax reform that includes a reexamination of tax expenditures associated with fringe benefits. Others believe that the tax preferences accorded employee benefits are both proper and necessary to encourage employers to voluntarily provide such benefits to their employees.

Definition of Tax Expenditures

Tax expenditure estimates represent reductions in individual and corporate income taxes as a result of tax revenues forgone. These expenditures generally result from provisions in income tax laws that provide economic incentives or tax relief to certain taxpayers. These provisions can take the form of exclusions, credits, deductions, preferential tax rates, or deferrals of tax liability. In this report, we are dealing primarily with discretionary benefits provided by employers that are excluded from employee income

(health and life insurance and flexible benefits) and deferrals of tax liability (pensions).

Tax expenditures can be viewed as entitlement programs that are not subject to the annual appropriations process and that are available to individuals and employers because (1) individuals receive income that is not taxed and (2) employers deduct from taxable income funds spent for qualified activities. Each tax expenditure is measured in isolation, assuming all other tax-preferred investments (e.g., real estate and municipal debt) and allowable tax deductions (e.g., mortgage interest) remain in place. If a tax expenditure is to be eliminated, assumptions must be made about what proportions of previously untaxed income will be allocated to taxable and nontaxable forms. Because each one is measured in isolation, eliminating a combination of tax expenditures might produce a lesser or greater revenue effect than the sum of the amounts shown for each item separately.

Moreover, to the extent that replacement programs might be adopted, higher revenues received as a result of an elimination of a tax expenditure may not represent a net budget gain. Replacement programs could involve direct expenditures or loans, different forms of tax expenditures, or general reductions in tax rates.

Table 1.2 shows estimated tax expenditures for selected employee benefits for fiscal years 1975, 1980, 1985, and 1992. With the exception of the estimate for flexible benefits, which was prepared by the staff of the Joint Committee on Taxation, these estimates were prepared by the Department of the Treasury. We use tax expenditure estimates that were prepared by Treasury on a revenue-lost basis.

Table 1.2: Selected Employee Benefit Tax Expenditures (Revenue Loss) **and Tax Expenditures Relative to Individual Income Tax Revenues, for Selected Fiscal Years**

Dollars in billions

	Tax expenditures			
	1975	**1980**	**1985**	**1992**
Benefits reviewed				
Pensions	$5.2	$19.8	$48.5	$51.2
Health	3.3	12.1	21.1	33.5
Life insurance	.7	1.7	2.1	2.9
Flexible benefits[b]	[a]	[a]	[a]	3.5
Other related benefits				
Individual retirement accounts and Keoghs	.4	1.9	14.7	9.0
Untaxed Medicare benefits	[a]	[a]	[a]	6.7
Individual medical expenses	2.3	3.2	4.5	3.2
Workers' compensation insurance	.5	2.2	2.2	3.3
Tax expenditures as a percent of individual income tax revenues				
Benefits reviewed				
Pensions	4.3%	8.1%	14.5%	9.7%
Health	2.7	5.0	6.3	6.3
Life insurance	0.6	0.7	0.6	0.6
Flexible benefits[b]	[a]	[a]	[a]	0.7
Other related benefits				
Individual retirement accounts and Keoghs	0.3	0.8	4.4	1.7
Untaxed Medicare benefits	[a]	[a]	[a]	1.3
Individual medical expenses	1.9	1.3	1.4	0.6
Workers' compensation insurance	0.4	0.9	0.7	0.6

[a]Not available.

[b]Prepared by the Joint Committee on Taxation.

Source: U.S. Department of the Treasury.

Estimated tax expenditures for the benefits we reviewed increased from about $9 to $91 billion between 1975 and 1992. They amounted to about 7.5 percent of individual income tax revenues in 1975 and will grow to an estimated 17.3 percent of projected revenues by 1992.

Tax Preferences Result in Benefit Recipients and Nonrecipients Being Treated Differently

The favorable tax treatment afforded the benefits we reviewed helps employees by allowing them to (1) receive benefits without including in current taxable income either the value of benefits earned or their employers' cost of providing benefits[2] or (2) defer taxes on retirement benefits until they are distributed. When taxes are deferred, employees benefit from the time value of money and from tax rates that may be lower than the rate in effect when the benefit was earned. Furthermore, because benefits are not included in employee income, neither employees nor employers have to pay payroll taxes on their value. This special tax treatment of fringe benefits makes them more attractive to employees than they would be if they were taxed in the same way as wages and salaries. In responding to this favorable treatment, employers may try to shift their compensation in the direction of more tax-favored fringe benefits.

Favorable tax treatment for certain types of compensation has the potential for generating horizontal and vertical inequities in the income tax system. Horizontal inequities occur when employees who receive the same before-tax compensation pay different amounts of tax because their mix of salaries or wages and fringe benefits differs. Horizontal equity would exist if employees who received the same before-tax compensation paid the same amount of tax.

Vertical equity relates to how the tax code treats individuals with different incomes. If, as a percentage of salary, individuals with higher incomes received greater tax savings resulting from tax-preferred benefits than individuals with lower incomes, vertical equity could diminish.

Tax-preferred benefits generate tax savings that depend on the amount of compensation that is tax preferred as well as on the tax rate structure. If, in moving from lower to higher incomes, tax-preferred compensation increases at a greater rate than salary, vertical inequity results. Such a situation can exist even under a flat rate or proportional income tax system because the value of the tax savings increases as a proportion of income.

[2]For most fringe benefits, a measure of the value of the benefit employees receive is the employers' cost of providing the benefit. For example, in the case of health benefits, the value of the benefits received by employees is the employers' cost of providing them with health insurance coverage and not the value of medical services they might receive. In the case of many defined benefit pension plans, however, the value of benefits received in the current year is based on such factors as an employee's salary and age, years of service, and mortality and interest rates. These factors are used to calculate "present values of accrued benefits" earned by employees in the current year.

Since statutory tax rates are progressive—they increase with income—vertical inequity can result even if tax-preferred benefits are proportional to compensation. For example, individuals earning $25,000 annually, who are in the 15-percent tax bracket, would save $150 in taxes if they received tax-preferred fringe benefits with a value of $1,000, or 4 percent of income. Tax savings, in this case, are 0.6 percent of income. However, individuals earning $50,000 annually, who are in the 28-percent tax bracket, would save about $560 on $2,000 in fringe benefits (also 4 percent of income). In this case, however, tax savings are about 1.1 percent of income. Horizontal and vertical equity will be discussed in subsequent chapters, where appropriate.

Objectives, Scope, and Methodology

Employer-provided fringe benefits represent an important component of a worker's compensation and a sizeable percentage of all tax expenditures calculated by the Department of the Treasury. In fact, because fringe benefits are not included in the tax base, the federal deficit is larger or, alternatively, tax rates are higher than they would be if such benefits were a part of taxable income. In addition, because tax expenditures for fringe benefits are so large, the preferences received by these benefits are continually being questioned by Congress and by policy analysts in the quest to (1) raise federal revenues, (2) lower federal income tax rates, (3) expand benefit coverage, or (4) redirect federal spending. In addition, some economists, as well as other analysts, are concerned with improving equity between benefit recipients and nonrecipients.

On the other hand, the federal government has encouraged private employers to provide tax-preferred fringe benefits to their employees in the form of retirement income and health and life insurance protection. If these benefits were not provided through employers, the federal government might be called upon to establish and expand national programs to meet employees' needs. In fact, there have been several recent proposals to improve employee benefit coverage. These include (1) requiring employers to provide all employees with basic health insurance that meets certain minimum standards or to pay a tax assessed as a percentage of wages, (2) encouraging small employers with 100 or fewer employees to establish pension plans that would make contributions to individual employees' accounts in return for reducing the paperwork normally associated with pension plans and no longer subjecting these plans to currently applicable nondiscrimination testing, and (3) restoring the eligibility rules for fully deductible individual retirement contributions to their status before the Tax Reform Act of 1986.

Before attempts are made to change the tax treatment of fringe benefits or expand benefit coverage through the tax system, evaluations of the current tax treatment of fringe benefits are needed. Our review focused on how the current system of taxation developed and how certain proposed changes might help the system achieve its stated goals at a lower cost or with fewer negative side effects. In this regard, we did not review each and every proposal that has been made to change the tax treatment of fringe benefits. Instead, we concentrated on certain representative types of proposals that proponents say will achieve particular equity or efficiency goals. Neither did we review in detail proposals that would either increase tax expenditures or use revenues from taxing benefits to finance additional benefit coverage. In addition, we take no position on whether changes to existing fringe benefit tax policies should be adopted.

Because deficit reduction and improved benefit coverage are issues Congress will deliberate on regularly, we (1) examined the early history of several of the more popular fringe benefits, (2) obtained information on the current recipients of these benefits and on estimated tax expenditures associated with them, and (3) discussed the possible implications of changing current employee benefit tax policies.

Our objectives for the benefits we reviewed—pensions, health and life insurance, and flexible benefits—were to (1) present historical and legislative background information on their development, (2) examine the extent and breadth of benefit coverage, (3) present tax expenditure estimates, and (4) discuss possible changes to the tax treatment of these benefits and the implications of such changes.

In developing the historical and legislative background information, we relied on information from the Employee Benefit Research Institute (EBRI), the American Council of Life Insurance (ACLI), the Congressional Research Service (CRS), and committee and conference reports prepared by House and Senate committees and subcommittees with jurisdiction over employee benefit tax policy. We also reviewed congressional testimony on employee benefit tax policy issues, publications and articles pertaining to fringe benefits, and summaries of legislation describing provisions in the Internal Revenue Code affecting selected employee benefits.

In researching tax expenditure data, we used Treasury estimates, the staff of the Joint Committee on Taxation's fiscal year 1992 estimate for flexible benefit plans, and compendiums of tax expenditures prepared jointly for

the Senate Budget Committee by its staff, the staff of the Joint Committee on Taxation, the Congressional Budget Office (CBO), and CRS.

We obtained information on the extent and breadth of benefits from the Departments of Health and Human Services, Labor, and Commerce; EBRI; and private benefits consulting firms. When appropriate, we discussed the information with officials from these organizations. For selected information on pension and health benefits, we analyzed data from the Department of Commerce's Bureau of the Census' Current Population Surveys (CPS). These surveys, which are conducted monthly, are the source of most official government statistics on employment. For each survey, a probability sample of about 60,000 housing units is selected on the basis of geographic areas. Although CPS' main purpose is to collect individual work history data and information on the employment situation, an important secondary purpose is to gather information on the demographic status of the population. Periodically, supplementary information on such subjects as health insurance coverage, pension benefits, and pension coverage are collected as part of the monthly surveys. For this review, we made particular use of information from the May 1988, March 1989, December 1989, and March 1990 supplements.

We obtained other information on the availability of employee benefits from the Department of Labor's Bureau of Labor Statistics (BLS). BLS has surveyed detailed provisions of selected employee benefit plans for medium- and large-sized employers since 1979. The 1989 survey contains information on benefits provided to employees who worked for employers with 100 or more employees. It provides representative data for 32.4 million full-time employees in the nation's private nonagricultural industries—about 45 percent of the private workforce. For information on benefits provided by state and local governments, we used BLS' 1987 and 1990 surveys of benefits. The 1987 study provides representative data for 10.3 million full-time state and local government employees—nearly 69 percent of the full-time public workforce. At the time we prepared this report, only summary information was available from the 1990 survey of employee benefits in state and local governments. We also used data from BLS' 1990 survey of employee benefits in private establishments with fewer than 100 employees.

EBRI was another source of information on benefits. EBRI was established in 1978 as a public policy research organization to provide up-to-date information on trends in employee benefits. In addition to funding its own research, EBRI has on occasion cooperated with federal agencies in funding

CPS supplements. Many of the tables and charts contained in EBRI publications are based on tabulations of data obtained from the Bureau of the Census or BLS.

In researching possible changes in employee benefit tax policy, we reviewed 1984 and 1985 Treasury reports on tax reform for fairness, simplicity, and economic growth; annual reports on budgetary options prepared by CBO; and selected legislative proposals and articles from the economics literature.

We recognize that the data for this report came from a multitude of sources, cover different time periods, use slightly different cutoff ages, or define segments of the workforce differently. However, in our opinion, these differences do not generally affect our presentation of the material in this report. In addition, we excluded other employee benefits, such as employee stock ownership plans, educational assistance, child care services, and legal services, because tax expenditures associated with these benefits were smaller or the benefits were less frequently provided than those we reviewed. Also, we did not examine how employers chose which benefits to provide to their employees or how they made decisions about the size of their benefit packages. At the same time, we assumed that employers will continue to have wide flexibility in designing their own benefit packages—i.e., there will be no government programs mandating such benefits as health insurance or child care.

Because of the informational nature of this report, we did not obtain agency comments. However, we did send a copy of the draft report to several experts in the tax and fringe benefit issues discussed in this report. We received many helpful comments that were incorporated in this report.

We did our work between January 1990 and November 1991 in accordance with generally accepted government auditing standards.

Pensions—an Important Fringe Benefit That Is Not Available to All Employees

Employer-sponsored pension plans, along with Social Security and private savings, provide millions of retirees and their families with retirement income. Active workers either accrue pension benefits or have funds placed in accounts in their name, depending on whether employers sponsor defined benefit or defined contribution pension plans.[1]

Congress uses tax preferences to encourage employers to sponsor pension plans and employees to provide savings for their future retirement. This preferential treatment amounts to the single largest tax expenditure in the federal budget—an estimated $51 billion in fiscal year 1992. Other tax preferences exist that individuals can use to save funds for retirement purposes. For the most part, this chapter deals only with employer-sponsored pension plans.

According to CPS data, employees who are more likely to participate in employer-sponsored pension plans work for governmental units, belong to labor unions, earn higher salaries, are older, and work for larger employers than those who do not participate. However, of the 103 million civilian workers in the public and private sectors, only about 45 percent participated in an employer-sponsored pension plan in 1988. Additionally, about 40 percent of an estimated 23.7 million households with retirees received pension benefits in 1989.[2]

Since 1974, Congress has enacted numerous laws with provisions that have restricted or limited tax preferences accorded to participants in qualified pension plans. Among other things, these provisions are intended to encourage a more equitable distribution of pension and tax benefits among workers. Even with these changes, tax inequities exist between recipients and nonrecipients of pension benefits, as well as among benefit recipients in different tax brackets. More recently, concerns about the budget deficit and selected investment practices of pension fund managers have resulted

[1]In a defined benefit plan, employers promise employees specific benefits generally on the basis of employees' years of service and earnings. For example, under such a plan, pension benefits paid at retirement could equal one percent of final salary times total years of service. In general, at retirement employees would have earned pension benefits during their careers which have an annuity value that will provide them with a stream of benefits payable until death. The amount of these benefits employees earn in a particular year depends on the result of calculations that consider such factors as age, salary, years of service, and mortality and interest rates. For defined contribution plans, many employers make contributions to employees' accounts on the basis of a percentage of salary. Retirement benefits are based on contributions to and investment earnings on these accounts.

[2]For this study, we defined households with retirees using December 1989 CPS data in which respondents indicated they were either (1) retired or (2) in the labor force for at least 5 years, not working, and 60 years old or older.

in proposals either to further limit the tax preferences provided to pensions or to tax certain pension plan investment transactions.

Under current tax law, employees generally pay taxes on their pension benefits when they receive them and not when these benefits are earned. Some employer and employee groups and pension fund advocates believe that taxing pension funds for either equity or revenue-raising purposes runs counter to the government's historical interest in encouraging and expanding pension plan coverage and could have a detrimental effect on the continuation of existing plans. Those who advocate current taxation of pension benefits on the basis of benefits earned are generally concerned with inequities between those who participate in pension plans and those who do not. There is also concern that the large tax revenue losses associated with pensions are larger than warranted compared to what they believe is a small net addition to personal savings resulting from pensions. In addition, Congress and others are concerned that some individuals with pension funds set aside for retirement income are actually withdrawing them for other purposes.

If, for either equity or revenue-raising reasons, pension benefits were attributed to individuals and taxed when they were earned rather than when they were received, employees who were the oldest and closest to retirement would generally face the largest increases in taxable incomes because of the way in which plan participants accumulate pension benefits. In addition, employers sponsoring pension plans would be faced with the increased costs of providing employees with information on amounts of pension benefits earned in the current year. Alternatives that would tax pension funds rather than individuals would not affect older workers as much or involve as large an increase in administrative cost. However, such approaches would not tax on the basis of individual income and, therefore, would not be as equitable.

Pension Plans Established to Provide Retirement Income to Employees

Employers began establishing pension plans in the late 1800s. Many of these early plans were established in the railroad, banking, and public utility industries. Employers established these plans to provide benefit

payments to their retired employees and to reward employees for long service.[3] Employers also established pension plans to (1) meet current employees' desires to protect themselves against reduced income in retirement, (2) supplement employees' Social Security income and personal savings with pension benefits, and (3) compete with other employers in attracting and retaining staff.

Employers sponsor either defined benefit or defined contribution plans or both. In a defined benefit plan, retirement benefits are determined through a formula based generally on employees' years of employment, earnings, or both. The employer is responsible for providing sufficient funding so that the plan can pay promised benefits. In some cases, employees are also required to make contributions to these plans. In a defined contribution plan, each participant has an individual account. Account balances at retirement depend on employer (and possibly employee) contributions allocated to the account. These contributions are usually in proportion to an employee's earnings and a share of investment earnings on plan assets.

Each plan type has advantages and disadvantages for employees. Defined benefit plans provide predictable retirement benefits that typically are tied to earnings in the years immediately before retirement. Employers bear the risk of the plan's financial performance and benefits. These benefits, up to a certain level, may also be guaranteed by the Pension Benefit Guaranty Corporation (PBGC)[4] should the plan fail. However, because benefits are usually frozen when an employee leaves employment, benefits are not adjusted for inflation or future earnings growth. Thus, individuals who worked for many different employers with defined benefit pension plans would tend to receive fewer benefits than otherwise similar individuals who worked for the same employers throughout their careers.[5]

In contrast, defined contribution plans are more advantageous to short-term, mobile workers than defined benefit plans. Mobile workers prefer defined contribution plans because assets generally build at a faster

[3]In addition to single-employer and government pension plans, some labor unions have negotiated collective bargaining agreements with employers for contributions to fund pension plans that cover workers who belong to the same union but work for different employers. These plans are called multiemployer plans.

[4]See page 29.

[5]Pension issues related to individuals who worked for many employers during their careers are discussed more thoroughly in our report Private Pensions: Portability and Preservation of Vested Pension Benefits (GAO/HRD-89-15BR, Feb. 3, 1989).

rate in the early years of participation and because these assets continue to grow even after an employee discontinues employment with that employer. The main disadvantage of a defined contribution plan is that employees bear the risk associated with the investment performance of the assets controlled by the pension plan.

Significant pension plan growth has occurred since the mid-1940s. Before 1946, employers had established about 7,300 defined benefit and defined contribution plans, according to the Department of Labor.[6] As of 1987, private employers sponsored over 870,000 pension plans and governmental units sponsored about 2,400 plans. While only 28 percent of all plans were defined benefit plans in 1985, they covered about 47 percent of all active participants. In addition, about 40 percent of all covered workers participated in two plans, generally a defined benefit and a defined contribution pension plan.

In addition to the role that pensions play in providing benefits to retired employees, pension funds with assets over $2.7 trillion in 1989 are important to our nation's economy. In 1987, pension plans owned about 40 percent of all U.S. holdings of corporate and foreign bonds and about 25 percent of all corporate shares.

Laws Grant Tax-Favored Status to Pension Plans, but Not Without Limitations

Before 1921, revenue laws contained no specific provisions for the tax treatment of pension, profit sharing, or stock bonus plans. Employers were generally allowed to take tax deductions for amounts contributed to these pension trusts and either the employer, employee, or the trust itself paid taxes on trust income.

The Revenue Act of 1921 (Public Law 67-98) encouraged employers to establish trust funds to pay employees' retirement benefits. Under this act, if a stock bonus plan or a profit-sharing plan were established for the exclusive benefit of the employees, the government would not tax either trust contributions or trust income until funds were disbursed to plan participants. The Revenue Act of 1926 (Public Law 69-20) extended this tax deferral to pension plans.

The Revenue Act of 1942 (Public Law 77-753) appears to be one of the first pieces of pension legislation enacted to address concerns that

[6] Helen H. Lawrence, "Trends in Private Pension Plans," Trends in Pensions (U.S. Department of Labor, 1989).

employers were establishing pension plans in a discriminatory manner. High-ranking officials were setting up pension trusts for themselves without regard to other employees in the company. The purpose of this legislation was to encourage employers to set up pension plans for all employees, rather than just officers and highly paid employees. To ensure that plans covered others besides officers and highly paid employees, the 1942 act required that a plan meet one of several participation tests for measuring discrimination (e.g., a minimum percentage of employees needed to be eligible for benefits under the plan).

The number of private employer-sponsored pension plans grew rapidly in the 1960s and 1970s. However, Congress was concerned that (1) many plans had overly restrictive age and service (years of employment) requirements for participation, resulting in the exclusion of many employees from plan benefits; (2) some plans were inadequately funded to meet future pension obligations; and (3) some individuals worked for employers that had not established a pension plan.

In addressing these concerns, Congress enacted the landmark Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93-406. ERISA attempted to provide for greater security and equity of private employees' pension benefits by establishing participation requirements, setting time frames over which employees' pension benefits become guaranteed (vesting standards), setting standards for funding current and past pension liabilities, and establishing individual retirement accounts (IRA) for those not in plans. Public-sector plans are not subject to ERISA requirements but are subject to several Internal Revenue Service (IRS) requirements.

ERISA also established PBGC as the government insurer of pension benefits for most individuals who participated in defined benefit pension plans that were unable to pay benefits. In addition, this legislation imposed overall limits on contributions and benefits allowed under qualified plans to prevent some individuals from accumulating pensions that were considered completely out of proportion to the needs of individuals for reasonable levels of retirement income. By 1991, after several amendments, limits on contributions to defined benefit plans were based on a maximum salary of over $222,000, and contributions to defined contribution plans were limited to $30,000. For defined benefit plans, the maximum yearly benefit distribution was nearly $109,000 for a 65-year-old retiree. Maximum benefit distributions are reduced for younger retirees.

Under ERISA, private-sector employers are prohibited from reducing employees' benefits that have already been earned, except when statutory changes in pension law are made. However, these employers could either amend the pension plan to pay reduced benefits in the future or terminate the plan, pay plan obligations, and establish a follow-on plan that would pay reduced benefits.[7]

Pension legislation following ERISA generally attempted to extend pension plan coverage to more rank-and-file workers by making plans less discriminatory and ensuring that these workers received at least minimum benefits. Important pension legislation enacted since 1980 includes the following:

- The Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) established special rules for "top-heavy" pension plans to curb perceived abuses in plans in which an employer's key employees were the primary beneficiaries.[8] Among other requirements, top-heavy plans must provide minimum benefits or contributions to nonkey employees participating in the plan.
- The Retirement Equity Act of 1984 (Public Law 98-397) sought to improve the likelihood that women would receive pension benefits. This act changed how retirees choose survivor benefits, how plans accounted for breaks in service, and how pension rights were assigned in divorce settlements.
- The Tax Reform Act of 1986 (Public Law 99-514) contained changes to correct perceived abuses and inequities in the delivery of benefits. Among other provisions, the act (1) reduced allowable differences in benefits between higher and lower paid employees in plans that coordinate or "integrate" benefits or contributions with Social Security retirement benefits, (2) modified coverage and participation rules to expand the number of workers participating in plans, and (3) imposed limits on annual compensation used to determine benefits or contributions.

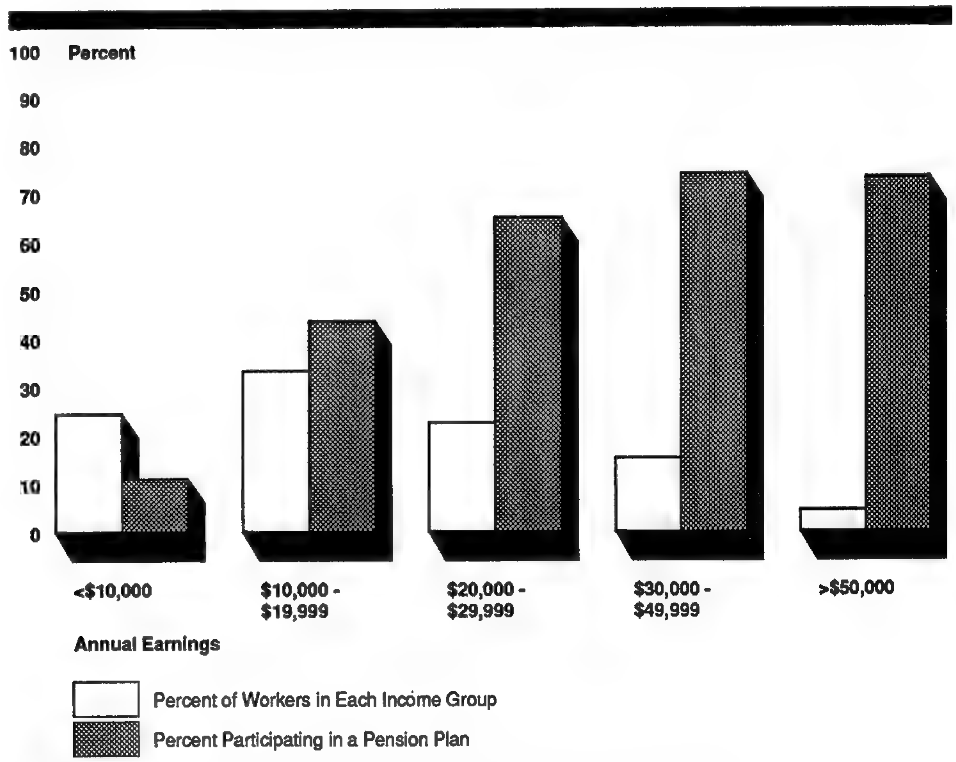
[7]Issues related to terminated pension plans are discussed in our following reports: Pension Plan Terminations: Recapturing Tax Benefits Contained in Asset Reversions (GAO/HRD-90-51BR, Nov. 22, 1989) and Pension Plan Terminations: Effectiveness of Excise Tax in Recovering Tax Benefits in Asset Reversions (GAO/HRD-90-126, July 13, 1990).

[8]Key employees include business owners and officers who meet certain compensation and ownership level thresholds. The definition of a key employee is found in section 416(i)(1) of the Internal Revenue Code.

Pension Coverage for Active Employees Varies by Worker Demographics

According to May 1988 CPS data, at that time about 55 percent of the 114 million civilian employees worked for employers that sponsored pension or retirement plans for their employees. However, only 42 percent of these workers participated in their employers' pension plans. CPS data showed that about 37 percent of the 86 million wage and salary workers in the private sector; 77 percent of the 17 million state, local, and federal government workers; and 21 percent of the 10 million self-employed workers participated in pension plans in 1988. Figure 2.1 shows that of the nearly 94 million wage and salary workers represented, those with higher annual incomes were more likely to participate in pension plans.

Figure 2.1: Percentage of Nonagricultural Wage and Salary Workers Participating in a Pension Plan, by Earnings (1988)

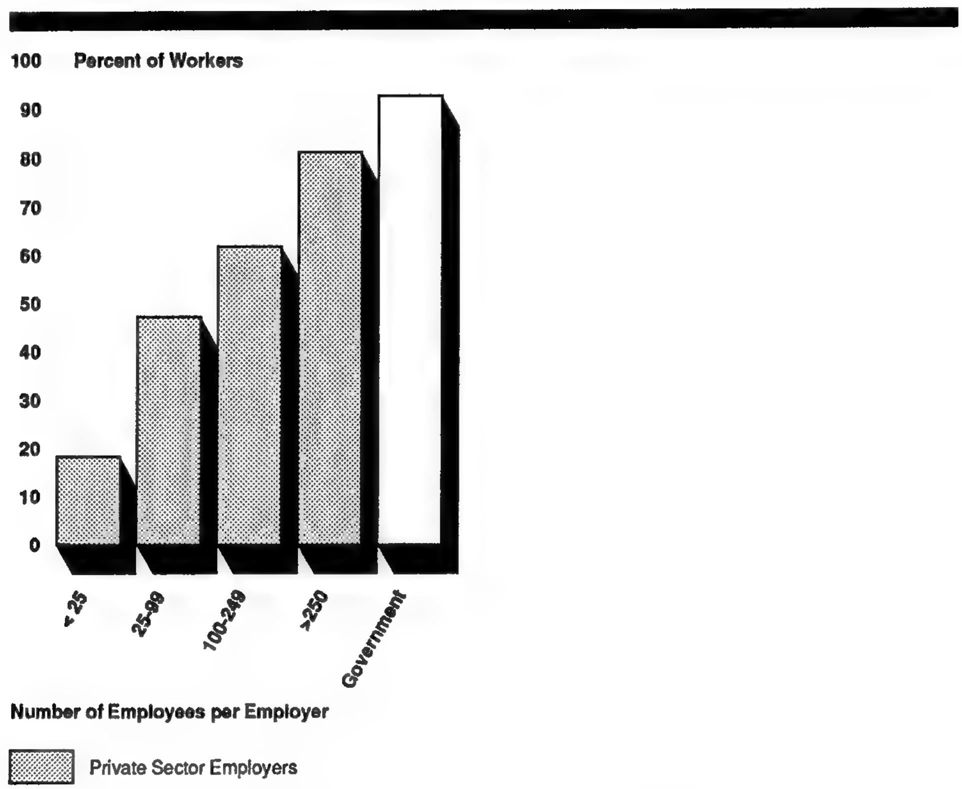


Source: EBRI tabulations from the May 1988 CPS employee benefit supplement.

For a variety of reasons, including the high fixed cost of pension plan administration, smaller private employers are less likely to offer pension plan coverage to their employees than larger employers and governmental bodies (see fig. 2.2). About 42 percent of the 76.9 million private-sector workers represented in figure 2.2 worked for employers with fewer than

100 employees. Of the 32.2 million workers who worked for these smaller employers, only about 28 percent worked for employers that offered their employees pension benefits.

Figure 2.2: Percentage of Nonagricultural Private-Sector Wage and Salary Workers Whose Employers Offered Retirement Benefits, by Size of Employer (1988)



Source: EBRI tabulations from the May 1988 CPS employee benefit supplement.

As shown in table 2.1, some industries are more likely to offer pension coverage than others.

Table 2.1: Percentage of Nonagricultural Wage and Salary Workers Covered and Participating in a Pension Plan, by Selected Industries (1988)

Industry	Millions of workers	Percent of workers: Covered	Percent of workers: Participating
Government	17.1	92%	77%
Communications and utilities	3.1	75	63
Manufacturing, durable	12.3	72	60
Mining	0.7	70	60
Finance, insurance, and real estate	7.4	69	49
Manufacturing, nondurable	9.0	68	53
Trade, wholesale	4.1	54	41
Transportation	4.3	51	39
Construction	6.1	34	27
Trade, retail	17.1	34	19

Source: EBRI tabulations of May 1988 CPS employee benefit supplement.

Table 2.2 shows that employees under 25 and 65 and over were not as likely as other workers to have coverage in either public- or private-sector pension plans. At any age, however, workers in the public sector were much more likely to have coverage than their private-sector counterparts.

Table 2.2: Percentage of Nonagricultural Wage and Salary Employees Whose Employers Offered Pension Plan Coverage, by Age of Employee (1988)

	Millions of workers		Percent of covered workers	
Age	Private	Public	Private	Public
Under 25	17.1	1.3	39%	80%
25 to 34	26.5	4.3	61	94
35 to 54	31.9	9.0	64	95
55 to 64	7.8	2.1	60	91
65 and over	1.9	0.4	38	83

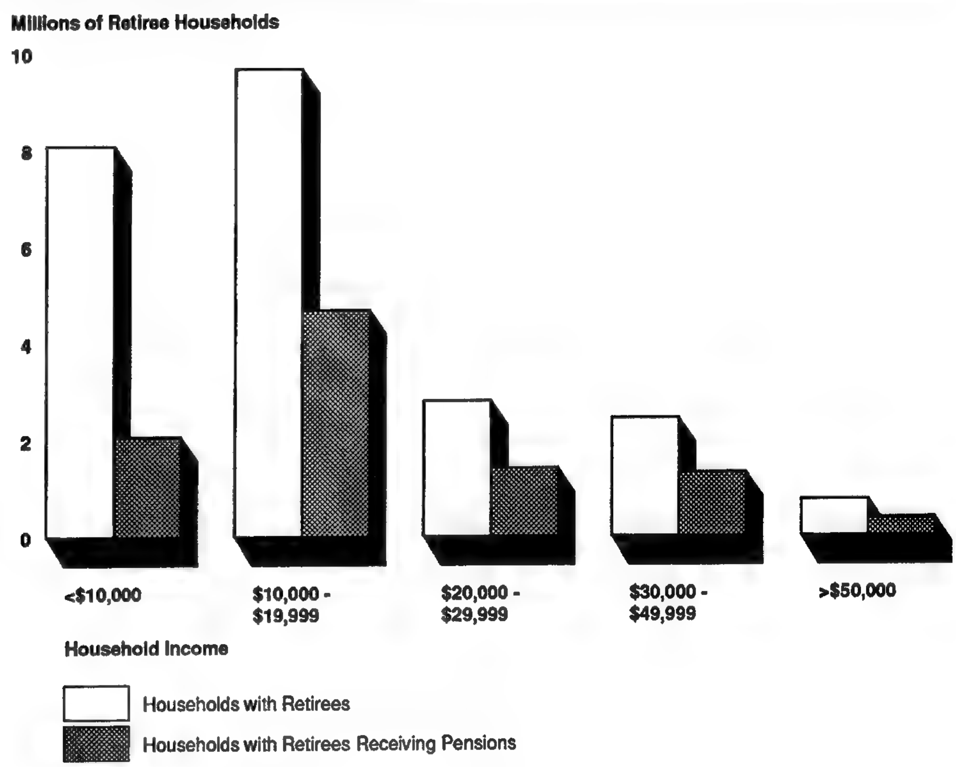
Source: EBRI tabulations from the May 1988 CPS employee benefit supplement.

Employees who belonged to unions were more likely to have coverage than nonunion employees. Of 10.8 million union workers who were employed in the private sector, 87 percent had coverage compared to 55 percent of the 67.5 million nonunion workers.

Pension Coverage for Retired Workers Was Less Extensive

According to the December 1989 CPS, about 40 percent of the 23.7 million household units with at least one retiree received pension income. Other income commonly received by these households included Social Security benefits, employment earnings, and income from assets. Figure 2.3 shows that over one-third of all retiree households had annual household incomes of less than $10,000 and that only about 25 percent of these households were receiving pension income.

Figure 2.3: Retiree Households Receiving Pension Distributions, by Amount of Total Household Income in 1989



Source: December 1989 CPS data.

Figure 2.3 does not consider that some retirees may have elected to take their pension benefits in the form of a lump-sum payment rather than as a monthly payment. As such, the number of retiree households that were initially entitled to pension benefits may be slightly understated. In some cases, retirees who opted for lump-sum distributions may have purchased annuity contracts with these funds.

Importance of Pensions to Retirees

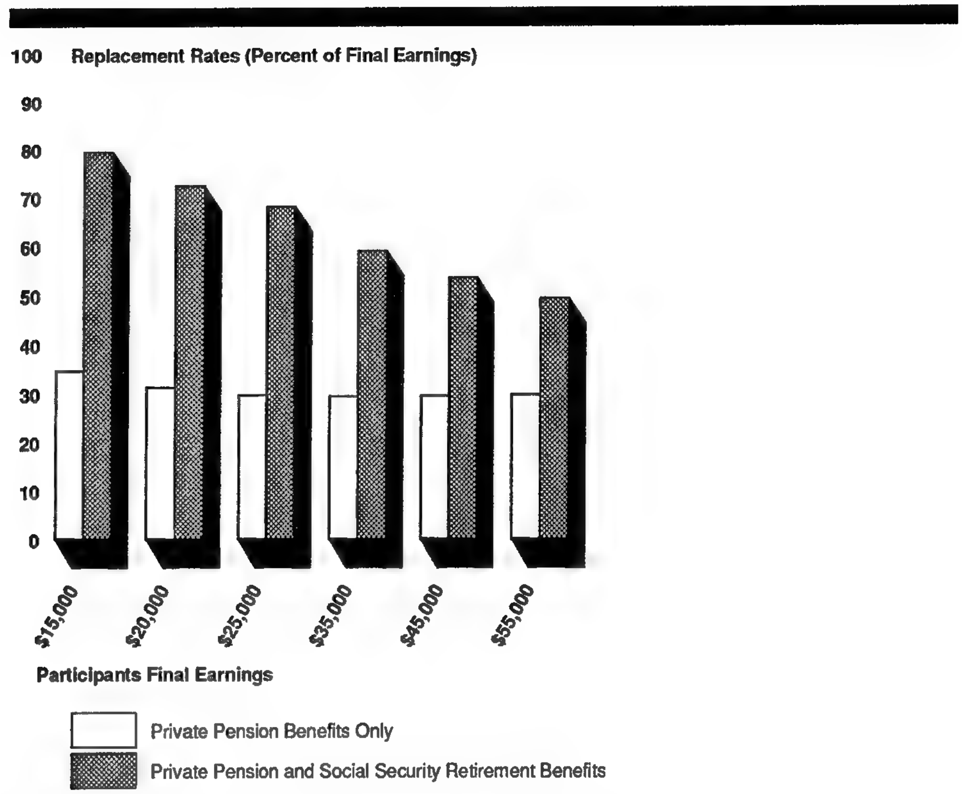
Pension incomes received by retirees vary considerably. For defined benefit pension plans, monthly pension benefits are determined by a number of different factors. These factors include salaries earned in the years just before retirement, formulas for computing benefits, years employed, and the extent to which plan benefits are integrated with Social Security retirement benefits.[9]

In pension plans with integration provisions, pension benefits were generally reduced by a factor that took into consideration the amount of Social Security benefits received. In 1988, about 60 percent of all participants in defined benefit pension plans sponsored by medium- and large-sized employers were in integrated plans. For some retirees in integrated plans, pension benefits as a percentage of retirement income could be relatively small.

The Tax Reform Act of 1986 made major changes in pension plan integration rules by setting limits on the permitted disparity between high- and low-paid employees. These changes, which were published in the Internal Revenue Service's (IRS) final regulations in September 1991, will require many pension plans to modify their plan integration provisions. Figure 2.4 shows the importance of private pensions and Social Security retirement benefits in terms of retirement income replacing final earnings. Much higher percentages of lower income employees' final earnings are replaced by this combination of retirement income.

[9]Issues related to pension plan integration are discussed in more detail in our following reports: Private Pensions: 1986 Law Will Improve Benefit Equity in Many Small Employers' Plans (GAO/HRD-91-58, Mar. 29, 1991); Private Pensions: Plan Provisions Differ Between Large and Small Employers (GAO/HRD-89-105BR, Sept. 26, 1989); and Pension Integration: How Large Defined Benefit Plans Coordinate Benefits with Social Security (GAO/HRD-86-118BR, July 21, 1986).

Figure 2.4: Replacement of Final Earnings by Pensions and Social Security Retirement Benefits for Participants With Selected Earnings Amounts (1989)



Note: Earnings replacement rates are based on 30 years of service.

Source: Employee Benefits in Medium and Large Firms, 1989, BLS.

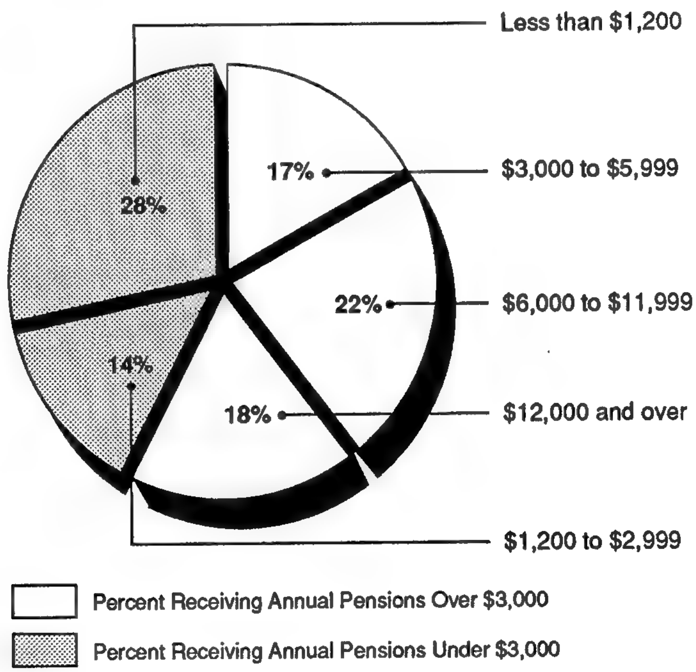
As shown, for workers with the lowest earnings who have pensions, private pension and Social Security retirement benefits replace larger portions of final earnings than those of higher paid employees. For retirees receiving only state and local government pensions, pension replacement rates in 1987 were, on average, just over 50 percent of preretirement earnings—about 17 to 22 percentage points greater than the rates received by private-sector employees. When combined with Social Security benefits, total income replacement rates for public-sector workers were about 3 to 12 percentage points higher than replacement rates for private-sector workers.

Private pensions, on average, replaced about 30 percent of a worker's final earnings for those who retired in 1989. Actual pensions received by employees can be severely eroded by inflation because most defined benefit pension plans do not adjust their retirees' initial pension payments

to consider cost-of-living increases. For medium- and large-sized firms studied by BLS in 1989, only 22 percent of the participants were in plans that provided, after the initiation of benefits, either annual or ad hoc cost-of-living increases to their retirees at least once from 1984 to 1988. From 1981 to 1985, 35 percent of the participants were in such plans.

While amounts of pension income received by retirees can be substantial, only about 40 percent of the 23.7 million households with retirees received pension income in 1989. For about 6.5 million households receiving pensions for which retirement income information was available, about 40 percent had annual pension income of less than $3,000, as shown in figure 2.5.

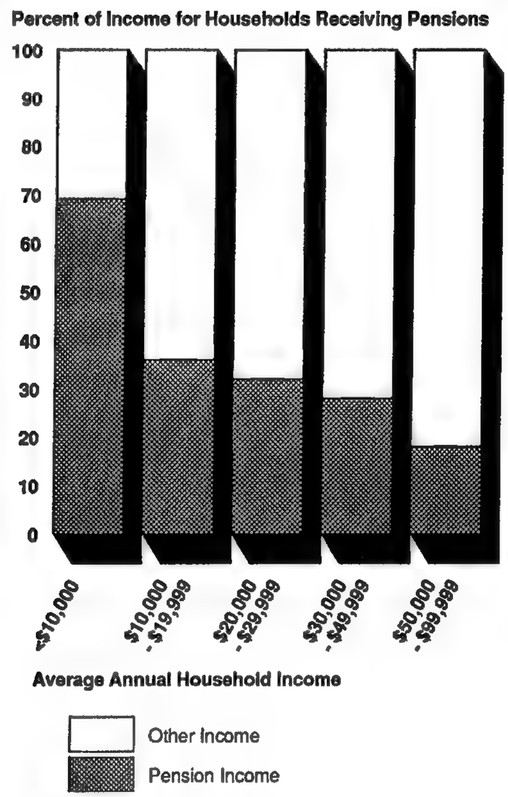
Figure 2.5: Percentage of Households With Retirees Receiving Pension Income, by Size of Pension Received (1989)



Source: December 1989 CPS data.

For all U.S. households with any member 65 years old or over and classified as an "aged unit,"[10] pension income represented about 16 percent of total income in 1988. Median income for these households was nearly $12,200. For households with retirees receiving pension income, pensions represented about 32 percent of total household income. Figure 2.6 shows that for households with the lowest annual income, pension benefits made up the largest share of household income.

Figure 2.6: Pension Income as a Percentage of Total Income for Households Receiving Pensions (1989)

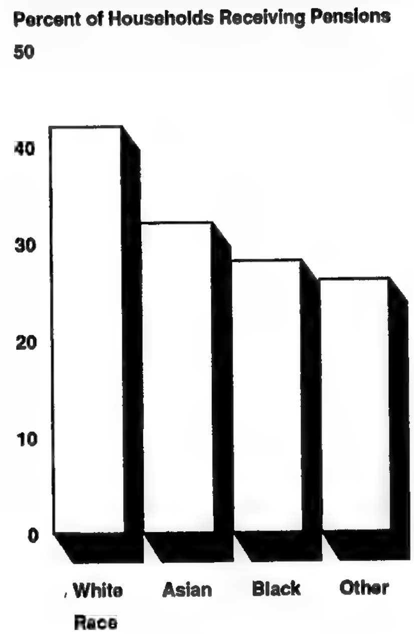


Source: December 1989 CPS data.

[10]An "aged unit" is either a married couple living together or a nonmarried person. It does not include aged persons living with younger relatives.

Figure 2.7 shows that for all households receiving pensions a greater percentage of those with white heads of households were likely to receive pension income than households headed by individuals of other races.

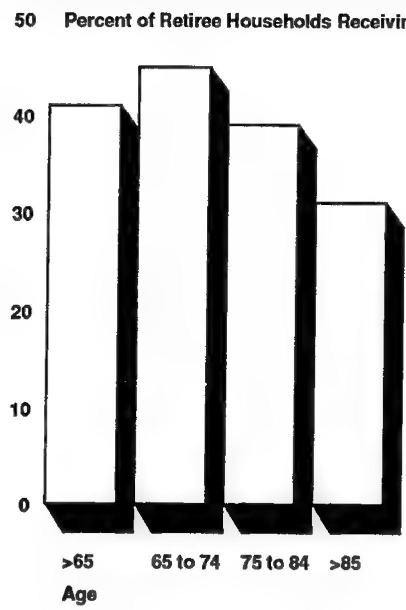
Figure 2.7: Household Receipt of Pension Income, by Race (1989)



Source: December 1989 CPS data.

Figure 2.8 shows that older retirees were less likely to receive pension benefits than younger retirees. Some older retirees may have retired before the enactment of ERISA and, therefore, may not have had the same pension protection as more recent retirees.

Figure 2.8: Household Receipt of Pension Income, by Retiree Age (1989)



Source: December 1989 CPS data.

Tax Expenditures for Pensions and Other Types of Retirement Income

For fiscal year 1992, estimated tax expenditures for public and private employer-sponsored pension plans were $51.2 billion. These expenditures arise because employees are not required to include these amounts in current taxable income. Pension fund managers, in turn, invest these contributions in stocks, bonds, and other assets to earn investment income, which also receives tax-deferred treatment. Employees are then taxed when they start receiving pension benefits. Thus, taxes on pensions are said to be deferred. Moreover, individuals having lower taxable incomes in retirement than when employed may receive additional tax advantages because tax rates on their retirement income may be lower than the rates in effect when they earned the benefits.

Treasury's tax expenditure estimate for employer-provided pensions is based on taxes forgone on (1) employers' pension plan contributions for current workers and (2) earnings on pension plan investments. From this total, taxes that retired workers pay on pension benefits received in the current year are subtracted to reach net tax expenditures. Treasury's estimates are prepared on a cash basis.

Some pension experts disagree with Treasury's method of computing tax expenditures and suggest that it significantly overstates the true long-term

tax expenditures. Instead of basing tax expenditures on pension plan contributions and earnings on these contributions minus taxes retirees pay on pension benefits received, these experts believe that a better method for calculating these tax expenditures exists. Called the present-value[11] method, this method subtracts the present value of taxes that current plan participants are expected to pay on pension benefits that will be received in the future from taxes forgone on current employer contributions and earnings on pension fund assets. Although these experts believe that the present value method is better, recent estimates of tax expenditures using this method were not available.

Other Retirement Income Tax Expenditures

Employer-sponsored pension plans are not the only tax expenditures associated with providing individuals with retirement income. Other types of retirement income for which Treasury has estimated tax expenditures include the following:

- The exclusion of some Social Security benefits from taxation results in $18 billion in tax expenditures. Only a portion of the Social Security benefits received by higher income taxpayers are presently taxed.
- The exclusion of some IRA contributions and all IRA earnings from taxation until retirement results in a $7.3 billion tax expenditure. IRAs allow employees who work for employers who do not have pension plans to set aside pretax dollars for retirement income purposes. Employees with taxable incomes that do not exceed specified amounts may also purchase IRAs with pretax dollars, even if their employers sponsor plans. Employees who are in plans and have taxable incomes that exceed the specified amounts may purchase IRAs with after-tax dollars. In any case, earnings are not taxed until after retirement.
- The exclusion of Keogh plans for self-employed individuals results in a $1.8 billion tax expenditure. Under Keogh plans, self-employed individuals must also make pension plan contributions for their employees. Keogh plans generally allow much higher contributions than are allowed under an IRA.

[11] Present values are sums of money that, if invested now at a given rate of compound interest, will accumulate to specified amounts at specified future dates.

Implications of Changing Pension Benefit Tax Policy

Ways of taxing pension benefits range from requiring employees to include the present value of currently accrued pension benefits in taxable income to having employers pay a tax on financial transactions involving pension assets. Full taxation of currently earned pension benefits could place a significant financial burden on some employees, particularly those closest to retirement.

Other alternatives to full taxation could raise less revenue and generally result in less improvement in tax equity. Most empirical studies relating pensions and taxation indicate that the taxation of pension benefits on a current-income basis would have a detrimental effect on pension coverage. Moreover, a recent study indicated that the effect is likely to be larger for workers in low-wage industries than for others.[12]

Taxation of pension benefits could also have unintended effects on national savings. Since national savings are an important source of financing for domestic capital formation, policies that affect savings can affect economic growth and our nation's future economic well-being.[13] Furthermore, significant changes in the current method of taxing pensions could require employers to pay increased costs to administer their pension plans. Some employers could view these cost increases as unacceptable, thereby reducing the likelihood of their maintaining pension plans for their employees.

Taxing Pensions Has Mixed Effects on Tax Equity

There are both proponents and opponents of changing current pension tax policy and requiring employees to include pension benefits in current taxable income. Advocates of taxation cite the need to improve tax equity as a reason to include pension benefits in current taxable income. According to these advocates, because less than half of the labor force participates in employer-sponsored pension plans, the current system exhibits substantial horizontal tax inequity. Employees with the same before-tax compensation could pay different amounts of tax depending upon whether they participated in employer-sponsored pension plans.

[12]Stephen A. Woodbury and Wei-Jang Huang, The Tax Treatment of Fringe Benefits, W.E. Upjohn Institute, Kalamazoo, Mich., 1991. This study is based on sophisticated empirical modeling of data from 1969-1982. The authors construct a simulation model to take into account changes in the tax treatment of fringe benefits. One concern is that the Tax Reform Act of 1986 made significant changes in marginal tax rates and that, therefore, the parameters empirically estimated for earlier years may not apply to the years after the Tax Reform Act of 1986.

[13]The importance of national savings is discussed more extensively in our report The Budget Deficit: Outlook, Implications, and Choices (GAO/OGC-90-5, Sept. 12, 1990).

Employees who may be most affected by this horizontal inequity are those who are less likely to have pension coverage, such as those who work for smaller employers or for employers in such industries as retail trade or construction.

Others argue that what appears to be horizontal tax inequity should not be a cause of great concern because workers who are not covered have taken into account the lower likelihood of pension coverage in choosing the industry or the size of the employer for whom they work. According to this view, employees who work for employers without pension plans are likely to receive compensating increases in other fringe benefits or salaries. Even if their taxes are higher, these workers may have strong preferences for current rather than deferred income. In addition, a recent Treasury report on technical services workers indicates that some workers may opt to be treated as independent contractors and not be subject to withholding taxes even if it means giving up some fringe benefits.[14]

Those who advocate taxing fringe benefits also focus attention on vertical equity. As noted earlier, vertical inequity occurs when tax benefits are disproportionately high for high-income groups. Such inequity can result either because the tax-preferred item constitutes a larger portion of income for higher income groups, or because those in higher tax brackets "save" more in taxes per dollar of benefit than those in lower tax brackets.[15] By flattening tax brackets, the Tax Reform Act of 1986 reduced but did not eliminate disparities in tax savings per dollar of tax-preferred income. In addition, while nondiscrimination rules may maintain equity within a pension plan, tax inequity can still arise within the plan because of differences in marginal tax rates. Furthermore, the most important sources of inequity come from differences either in the likelihood of being covered by a plan at all or in the level of generosity of the plan.

As shown in figure 2.1, the likelihood of participating in an employer-sponsored pension plan increases substantially with income. It is in this sense that the vertical equity of the tax system may be eroded. However, for those who are covered, figure 2.4 shows that private pension replacement rates do not increase but appear to decrease with, and then become proportional to, income. If the integration of pension plans with

[14]Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, Department of the Treasury, March 1991.

[15]Pension equity issues are discussed in more detail in our report Private Pensions: 1986 Law Will Improve Benefit Equity in Many Small Employers' Plans (GAO/HRD-91-58, Mar. 29, 1991).

Social Security retirement income is included, overall retirement income replacement rates fall substantially as income rises. Thus, even if there was vertical inequity from the standpoint of private pensions, there might be less inequity from the standpoint of overall retirement income.

While the existing tax treatment of pensions may raise tax equity concerns, it may be achieving its goal of providing retirement income security to those employees who participate in pension plans. The Woodbury and Huang study indicated that the amount of pension benefits extended to workers in low-wage industries is affected more by the tax deferral than are the pension benefits extended to workers in high-wage industries.[16] This difference may in part reflect the greater preference of high-wage workers for pension benefits, even without a tax preference. As a result, eliminating pension tax preferences could reduce pension coverage of low-wage workers by more than that of high-wage workers.

Changing Pension Tax Laws Could Have Unintended Effects on National Savings or on Pension Tax Expenditures

Including currently earned pension benefits in employees' taxable incomes could improve tax equity. Alternatively, horizontal tax equity could be improved by allowing nonparticipants in pension plans to increase their IRA contributions above the current statutory limit of $2,000. However, improving tax equity in these ways could adversely affect tax expenditures or national savings.[17] In the first case, government revenues would rise; however, if fewer employers sponsored pension plans, private savings could decrease as coverage declined. In the second, private savings could increase if additional pension plan contributions were allowed; however, because these contributions would not be taxed, government revenues would fall. Realistically, however, only nonparticipants with higher earnings might be in a position to make IRA contributions in excess of $2,000.

[16]Woodbury and Huang, p. 140.

[17]Total net national savings are the sum of net private savings, state and local government surpluses or deficits, and the federal government surplus or deficit. A common measure of the national savings rate is the total net national savings as a percentage of gross national product (GNP).

The economics literature contains a limited number of estimates of the responsiveness of pension savings to tax rates.[18] The Woodbury and Huang study estimated the elasticity to range from 1.5 to 3.0.[19] One reason these elasticities could be high is that the primary tax benefit of receiving compensation in pension form, rather than in current salary, comes largely from the tax deferral. Therefore, if the advantages of the deferral were eliminated and employees were taxed on benefits earned, employees would have less incentive to postpone receiving income, possibly taking the amounts previously set aside for pensions as salaries and wages. Many pension plans would probably continue even if pension tax preferences were reduced or eliminated because (1) employees are concerned about their financial needs in retirement and (2) some employers provide pensions for human resource reasons more than for the tax advantages. Conversely, those familiar with pension plan administration indicate that some employers facing higher costs of administering their plans either could decide to terminate their plans or substitute defined contribution for defined benefit plans.

Taxing all fringe benefits, including pensions in the current period rather than paying taxes on these benefits when they are received, is likely to reduce the amount of pension savings through employer-sponsored plans. However, the net effect on retirement savings is difficult to determine because some employees who are no longer covered by employer plans or whose coverage is reduced may save more on their own. In any event, because pensions would be taxed on a current-income basis, the additional tax revenues would, in effect, increase government savings (assuming government expenditures remained constant and tax revenues were not redistributed through lower tax rates). With these two effects—private savings falling and government savings increasing—the net effect on national savings is difficult to predict.

An alternative for improving tax equity between recipients and nonrecipients of employer-provided pension benefits could be to allow nonparticipants to contribute increased amounts to IRAs. While this solution might lead to some increased savings, it would probably also lead

[18]An important portion of our nation's private savings consists of assets held by and annual contributions to employer-sponsored pension funds. In 1989, public and private pension fund assets exceeded $2.7 trillion, with large holdings of corporate stocks and bonds. In 1987, private employer contributions and interest on their pension assets totaled nearly $109 billion.

[19]These elasticities are presented in absolute values; normally, they would have negative signs.

to increased tax expenditures for retirement income purposes and reduced tax revenues for the government.

Currently, an employee working for an employer that does not sponsor a pension plan can contribute a maximum of $2,000 in pretax dollars to an IRA. Depending on a worker's age and other factors, this amount could be much less than pension benefits earned by an employee in either an employer-sponsored defined benefit or defined contribution pension plan.[20] If the IRA limit were raised to allow individuals to deposit amounts into an IRA that had the same value as the current pension benefits some employees can earn, this could result in even larger tax expenditures for the government.

Controversy exists over whether IRA contributions actually represent new savings. Some studies measured an addition to savings above and beyond what would have occurred without IRAs while other studies indicated that most IRA contributions represent either savings that would have occurred anyway or the redistribution of previous savings into tax-deferred investments.[21] However, most studies agree that before the passage of the Tax Reform Act of 1986, which restricted the use of fully deductible IRAs for many employees, higher income individuals were more likely to take advantage of IRAs. As such, the expanded use of IRAs to satisfy horizontal equity concerns between pension recipients and nonrecipients may increase the budget deficit and exacerbate vertical inequity.

Burden and Equity Issues Affected by Taxation of Accrued Pension Benefits

If pension benefits were fully taxed when currently earned, the equity of the individual income tax system would be improved. However, because employees' taxable incomes could increase—some significantly—some employees could have difficulty paying the additional taxes on these benefits. Because of this effect, the full taxation of currently earned pension benefits would not seem feasible without some type of transition period. Only a portion of the increased taxable income from pensions would be taxed in the early years of the transition period.

Alternative options for taxing pensions that involve taxes on contributions to, or earnings of, pension funds or pension fund assets could also raise

[20] See limits on page 29.

[21] Jane G. Gravelle, "Do Individual Retirement Accounts Increase Savings?," Journal of Economic Perspectives (Spring 1991).

additional tax revenues. Although these options have certain administrative advantages, they would not generally bring about as much improvement in tax equity as would full taxation of pension benefits because they are not necessarily based on employees' incomes.

Full Taxation of Pension Benefits as Current Income Would Affect Employees Closest to Retirement the Most

Employees in defined benefit pension plans generally accrue the largest share of their estimated pension benefits in the years shortly before retirement. Therefore, if accrued benefits were considered income for tax purposes, those nearing retirement would generally face significant increases in their taxable incomes. For defined contribution plans, older workers with many years of service could also see increases in their taxable incomes because there could be greater investment earnings on pension fund assets that have had many years to grow.

For example, employees in many defined benefit plans earn pension benefits based on formulas that consider such factors as employees' earnings and length of service, earnings on pension plan assets, mortality assumptions, and pension payments.[22] A 30-year-old employee with 5 years of service and earning $25,000 annually, with a benefit formula that provided for a pension of 1 percent of salary times each year of service, would earn pension benefits of about $210 a year.[23] For a 60-year-old employee with 35 years of service and earning $25,000 annually, the estimated increase in the present value of future pension benefits would total about $8,155 a year.

For defined contribution plans, employees' annual pension earnings are often based on employers' contributions to an employee's account and investment earnings on the employee's account balance. When compared to defined benefit plan formulas, contributions and earnings that result in the same benefits at retirement as a defined benefit plan generally result in annual pension earnings that are larger in the early years of employment and slightly smaller as employees near retirement. Using the same assumptions as those used in the preceding paragraph, the employer would need to make a contribution to the employee's account of about 5 percent of salary (about $1,250). The total increase in the employee's account

[22]As discussed on page 20, we referred to the result of these calculations as the present value of accrued benefits.

[23]Other assumptions used to calculate accrued benefits were salary increases of 5 percent per year, an interest rate of 8 percent, and a normal retirement age of 65. Normal retirement age is a term used by pension plans to indicate the age at which an employee can retire without having benefits reduced.

would depend on the size of the account balance and the investment earnings on the balance.

For example, if the 30-year-old employee had an account with a balance of $8,000 that earned interest of 8 percent annually, the total increase in the account would be $1,890 (a contribution of $1,250 and interest of $640) compared to benefits of $210 earned under a defined benefit plan. For a 60-year-old employee with an account balance of $75,000, at 8 percent, the total increase for the year would be $7,250 (a contribution of $1,250 and interest of $6,000) compared to defined benefit plan earnings of $8,155.

For employees close to retirement who are in defined benefit plans, benefit accruals generally have less time to earn investment income. As such, accruals must be larger in the years just before retirement to reflect employees' retirement benefits, which are usually based on final salary. For younger employees, benefit accruals have longer to accumulate investment earnings. Generally speaking, this means that for employees in defined benefit plans, benefit accruals increase as employees get older, and older employees accrue more benefits annually than younger workers. For employees who have participated in defined contribution plans for many years, accruals are generally larger because these employees have larger account balances. Therefore, by including pension benefits in taxable income on a current-income basis, older employees earning the same salaries as younger workers would earn more pension benefits than younger workers. Consequently, older workers would generally have greater increases in their taxable incomes.

Cost to Administer Defined Benefit Pension Plans Could Have Detrimental Effects on Employers' Decisions to Maintain Plans

If current pension benefits were taxed at the individual level, employers that sponsor pension plans would be faced with increased record-keeping costs to administer any changes in pension tax policy. According to a September 1990 study on pension plan administrative costs conducted for PBGC, defined benefit plans cost more to administer than defined contribution plans of similar size. In our opinion, changes in current pension tax policy would also increase employers' pension plan administrative costs. We would expect these cost increases to be larger for defined benefit pension plans because of the need to compute individual employees' increases in the present value of their accrued benefits.

The September 1990 study also showed, among other things, that for pension plans of all sizes, the ongoing administrative costs increased

substantially from 1981 to 1991. For example, after adjustments for inflation, administrative costs for a defined benefit plan with 15 participants increased 181 percent to $455 per person. For a 10,000-participant plan, costs increased by 176 percent to $54 per participant. Most of these increases were related to increased consulting fees paid by the plan. For defined contribution plans, ongoing administrative cost increases ranged from 51 to 99 percent over the same period and, in 1991, were about $227 per participant for a 15-participant plan and $40 per participant for a 10,000-participant plan.

Other study results showed that the one-time costs to accommodate the frequent legislative and regulatory changes between 1981 and 1990 averaged $2,100 annually for a defined benefit plan with 15 participants and $7,000 annually for a plan with 10,000 participants. For defined contribution plans, average annual one-time costs ranged from $1,500 to $5,300 for similar-sized plans. The report concluded that the administrative costs per person for a large plan were not great enough to drive the decision to select or continue a defined benefit plan. On the other hand, with high average costs for administering a small defined benefit plan, small employers would be more likely to limit their consideration to defined contribution plans, which are less expensive to administer.

One reason defined benefit plans cost more to administer than defined contribution plans is that defined benefit plans must generally consider actuarial projections that take into account future numbers of employees, ages, earnings, and other demographic characteristics in computing contributions; defined contribution plans do not. In addition, the tax code and ERISA require (1) detailed and complicated actuarial disclosure reports from defined benefit plans and (2) payment of insurance premiums to PBGC to protect pension benefits in the event of plan termination.

Taxation of pension benefits as current income could increase administrative costs above current levels. If full taxation of each employee's accrued benefits is adopted, employers would have to establish record-keeping systems that would show year-to-year increases in the amount of employees' pension benefits included in taxable income. Yearly totals would be needed to distinguish between untaxed pension benefits previously earned and pension benefits that had been included in taxable income. Administration and control over records with this information would be expected to become increasingly complex as time passes because of such factors as employee turnover, mergers and acquisitions, and other business terminations.

Increased administrative costs associated with including pension benefits in individual employees' taxable incomes would represent still another round of pension rule changes. Some employers—especially smaller ones—could view these increases and changes as unacceptable and make determinations that it would be too burdensome to maintain pension plans for their employees.

Alternative Options Would Substitute Administrative Simplicity for Some Equity

In addition to the full taxation of currently earned pension benefits, other proposals and options for taxing pensions exist that would generally mitigate the disproportionate effect on older workers and involve less of an additional administrative cost for the employer. Instead of fully taxing currently earned pension benefits at the individual level, some countries tax the pension fund. For example, Australia imposes a 15-percent tax on contributions to, and earnings of, pension funds. When workers are paid pension benefits in retirement the tax rate applied to that income is reduced by 15 percent. New Zealand, on the other hand, imposes a flat 33-percent tax on all contributions and earnings. No tax is imposed when benefits are paid from the pension fund. A similar tax has been proposed for the United States.[24]

Proposals of this sort have the advantage of administrative ease. Because there is no need to attribute annual pension benefits earned to individuals, there would be less record keeping required. However, for a similar reason, proposals of this type do not necessarily tax workers on the basis of their ability to pay. If the single tax rate that is chosen is an average tax rate, some individuals could be paying at a rate that is higher than their current income tax rate and others at a lower rate. As a result, some equity benefits may be sacrificed for simplicity.

Other options for taxing pensions that have either been the subject of proposed legislation or discussed by CBO as part of its deficit reduction options since 1980 follow:

- One option calls for imposing a 5-percent tax on the investment income of qualified pension plans. This low tax rate would retain some incentive for retirement savings. At the same time, it could reduce the inequality of

[24]Alicia H. Munnell, Current Taxation of Qualified Plans: Has the Time Come?, American Law Institute-American Bar Association, Pension Policy Invitational Conference, Washington, D.C. (Oct. 1991).

taxation between higher paid and longer term employees versus lower paid, mobile workers, who gain the least from the current interest exclusion. Some employers might make larger pension contributions to cover the tax; others would reduce employees' retirement benefits. For the 5-year period ending in 1995, CBO estimated that this option, which would include taxing the investment income of IRAs and profit-sharing plans, would raise about $37 billion.

- Another option would impose a 0.5 percent securities transfer excise tax on the transfer of all stocks, bonds, and other kinds of securities. Because pension funds have portfolios that generally include these types of securities, they would incur a share of these taxes.
- Another proposal would reduce the maximum annual amounts upon which employers could base their contributions to an employee's pension plan. For example, the maximum amount that could be contributed to an individual's defined contribution plan could be reduced from $30,000 to $22,600. Or employees' salaries upon which contributions to defined benefit plans were based could be reduced to the amount of the Social Security wage base ($53,400 in 1991). For the 5-year period of 1991 to 1995, CBO estimated revenues resulting from these changes at $16.2 billion.
- Yet another option would place excise taxes of 10 percent on capital gains from assets held by pension funds for 30 days or less and 5 percent on gains from assets held more than 30 but less than 180 days. The aim of this proposed legislation was not to raise revenues but to limit pension funds from frequently turning over their investments and to promote long-term investment strategies, according to its sponsors.

Other options mentioned include (1) imposing an indirect tax on pension contributions by prohibiting companies from deducting a portion of these contributions as a business expense and (2) adding an excise tax to the current 10-percent penalty for premature distributions from a pension fund.

Except for the option that would reduce current limits on pension plan contributions for each employee or on maximum salaries upon which pension benefits could be calculated, these options would generally require employers to pay the tax at least initially (e.g., stock transfer excise tax, tax on pension fund earnings, or a tax on short-term gains on pension plan investments). Eventually, employers could pass these taxes on to employees in the form of reduced pension benefits or reduced wages. This would be particularly true of defined contribution plans in which taxes paid and administrative expenses incurred could be prorated to each

individual's account. While taxes of this type would raise revenues, both horizontal and vertical equity issues would remain because these taxes would not necessarily be based on amounts of pension benefits earned by employees.

Summary

Employer-provided pension coverage is available to a large segment of our nation's population. However, many individuals who earn lower wages or work for smaller employers lack coverage. Even though pensions can be an important factor in contributing to retiree income, as the largest tax expenditure, they are a lucrative target for those who wish to raise substantial amounts of revenue to reduce the deficit. Fully taxing pensions would likely improve the overall equity of the tax system but could also lead to even less pension coverage for workers currently covered and reduced private savings for retirement.

If pensions were taxed, some employers might opt to terminate their pension plans and possibly provide their employees with higher wages. These employees would become more responsible for planning to meet their financial needs in retirement. Eventually, pressure might be placed on the Social Security system to replace a greater share of employees' final earnings upon retirement. On the other hand, because many pension plans exist to meet employers' labor force needs or employees' retirement income needs regardless of the tax consequences, many plans might continue even if taxes on pension benefits earned were no longer deferred.

More modest changes could be made to improve tax equity and raise revenues short of full taxation. Such options as reducing the maximum allowable accrued benefit or taxing pension fund assets could be more easily administered than full taxation but would not bring about as much tax equity because they are not based on an employee's individual income.

Predicting the extent to which employees and employers would respond to changes in current pension tax policy is difficult. For example, to what extent would employees be willing to pay taxes as pension benefits were earned while still providing private savings for their retirement? Would employees attempt to persuade their employers to increase their current salaries and forgo pension benefits? To what extent would employees trade pension benefits for other tax-advantaged investments or fringe benefits? Would employers be willing to undergo still another round of tax code changes that would increase the cost of administering pension plans? To

what extent would employers terminate their plans or replace defined benefit plans with defined contribution plans?

An even more difficult question to answer than these is whether a change in pension tax policy would significantly affect national savings. On one hand, the additional revenue from taxing pensions could be substantial, thereby helping to reduce the drain on savings caused by the budget deficit. On the other hand, reduced pension coverage could result in decreased private pension savings.

Most Employees Receive Health Benefits From Employers, but Coverage and Cost-Sharing Disparities Exist

About 66 percent of the 213.7 million people under age 65 in the United States had employer-provided health benefits in 1989. Additionally, about 43 percent of all retirees age 40 and over received retiree health benefits through their own current or former employer. On the other hand, of the 34.4 million individuals under age 65 without health benefit coverage, more than 85 percent worked at least part of the year or lived in a family headed by a worker. Individuals with health benefit coverage had the same characteristics as those with pension coverage: they worked in many of the same industries, had higher incomes, were older, worked for larger employers, and belonged to labor unions.

While most employees had employer-provided health benefit coverage, the extent and breadth of coverage varied substantially. For example, in 1989, medium- and large-sized employers paid 100 percent of the insurance premiums for over 50 percent of the full-time employees with individual coverage and for about 35 percent of the employees with family coverage. Deductibles ranged from under $50 to over $300, maximum annual out-of-pocket expenses ranged from under $250 to over $2,500, and lifetime maximum health benefit payments ranged from less than $100,000 to no maximum limit.

According to Treasury, employer-provided health benefits are the third largest tax expenditure, estimated to total $33.5 billion in fiscal year 1992 (6.3 percent of individual income tax revenues) compared to $3.3 billion in 1975 (2.7 percent of individual income tax revenues). As a percentage of total compensation, employers' costs for providing this benefit more than doubled between 1970 and 1989.

During the 1980s, CBO options for reducing the federal budget deficit often included proposals to tax employer-provided health benefits. In general, these proposals either required employer-provided health benefits that exceeded a specified amount to be included in employees' taxable incomes or included the total value of these benefits in taxable income in exchange for a tax credit.

If all or a portion of the value of employer-provided health benefits were included in taxable income, improvements in tax equity would occur between benefit recipients and nonrecipients, recipients of different amounts of benefits, and high- and low-income employees receiving these benefits. In addition, employees would be expected to bargain with employers to economize in their selection or design of health care benefit packages. In turn, this could reduce incentives for overusing medical

services. However, some individuals might forgo needed medical care if less comprehensive health benefits were available from employers. The decision to reduce health benefits could adversely affect those who would delay medical treatment either because they could not afford it or chose not to receive it.

Growth of Employer-Provided Health Benefits

Employer-provided group health insurance coverage was first provided in the early 1900s. During the 1920s and 1930s, more private-sector employers, often encouraged by organized labor, began to offer in-house medical care and provide health insurance to their employees. During World War II, when the government restricted wage increases in an effort to stabilize prices, employers responded by offering a variety of benefits (including health benefits) instead of increasing wages. After World War II and up to the late 1950s, employers saw they could meet the needs of an increasing number of families by improving their compensation packages to include such fringe benefits as paid health benefits and paid vacations. By the late 1960s and extending into the 1980s, the practice of offering health care benefits became common for many employers.

According to a 1990 EBRI/Gallup public opinion survey, of all employee benefits, health benefits are most frequently cited as the most important employer-provided benefit. In addition, 78 percent of 1,000 U.S. adults surveyed in June 1990 preferred $2,500 worth of health benefits to $2,500 per year in additional pay.

In addition to meeting employees' demands for health benefits, employers provide these benefits out of concern for their employees' welfare and to compete in attracting and retaining valuable employees. Employers can also generally provide health benefits to their employees at a lower cost than employees would have to pay on their own for similar coverage, and employers can claim the cost of health benefits as a business expense that can be deducted from taxable income.

Legislative Provisions Affecting the Tax Treatment of Health Benefits

Before the enactment of sections 105 and 106 in the Internal Revenue Code of 1954, the tax treatment of health expenditures for employees was uncertain because there were no code provisions that addressed whether employer contributions for health insurance premiums should be included in employee income. The legislative history of the 1954 act stated that provisions dating back to 1918 and 1939 in effect caused considerable controversy. Individuals in similar situations were treated differently

depending on whether employer contributions were for group health insurance or for the purchase of coverage for individual employees. Amounts paid for individual policies were included in employee gross income.

Under the Internal Revenue Code, employer contributions for employee health protection have always been considered an ordinary business expense that an employer could deduct from taxable income. However, it took the passage of section 106 in 1954 to explicitly allow employer contributions for employee health plans to be excluded from an employee's taxable income. The legislative history of section 106 indicated that this section's principal purpose was to make uniform the tax treatment of employer contributions to group and individual health benefit plans. A 1982 Senate Budget Committee report stated that this clarification had the effect of encouraging the expansion of health benefit coverage, although that was not originally its major purpose.[1]

Over the years, Congress enacted other laws that contained provisions that affected employer-provided health benefits. These laws addressed such issues as (1) nondiscrimination in providing health benefits to high- versus low-paid employees; (2) continuation of employer-provided health benefits for a limited period of time after an event (layoff, death, or divorce) that otherwise would have terminated coverage; and (3) partial deductions of health insurance premiums by self-employed individuals. Congress enacted the law concerning self-employed individuals because it became aware that employer-provided health coverage was lowest for small employers, particularly for small, self-employed employers. The Joint Committee on Taxation's explanation of the change made by the Tax Reform Act of 1986 stated that "[t]he need for adequate health coverage is so important that the Congress believed it was essential to encourage a narrowing of the gap in health coverage." Congress also believed that the pre-1986 law created unfair distinctions between self-employed individuals and owners of corporations. Currently, self-employed individuals are allowed to deduct 25 percent of their health insurance costs from taxable income.

In addition to the legislative provisions that allow employers to claim health expenditures as a business deduction and employees to exclude from taxable income the value of employer-provided health benefits, the Internal Revenue Code also allows individuals to deduct unreimbursed

[1] Tax Expenditures: Relationships to Spending Programs and Background Material on Individual Provisions, Committee on the Budget, U.S. Senate, Mar. 17, 1982.

medical expenses that exceed a specified percentage of their adjusted gross income (AGI).[2] This deduction was first allowed in 1942 to maintain high standards of public health and to ease the burden of high wartime tax rates, according to a Senate Committee on the Budget's discussion of the rationale for the deduction.

Unreimbursed medical expenses that both individuals with and without employer-provided health benefits can deduct are based on AGI. Over the years, the percentage of AGI that medical expenses must exceed before they may be deducted from taxable income has changed several times. Currently, medical expenses above 7.5 percent of AGI are deductible. In 1985, 10.8 million of 101.7 million individual income tax returns contained a deduction for medical expenses compared to about 5.1 million of 112.3 million in 1989.

Employer-Provided Health Benefits Are Widespread but Not Universal

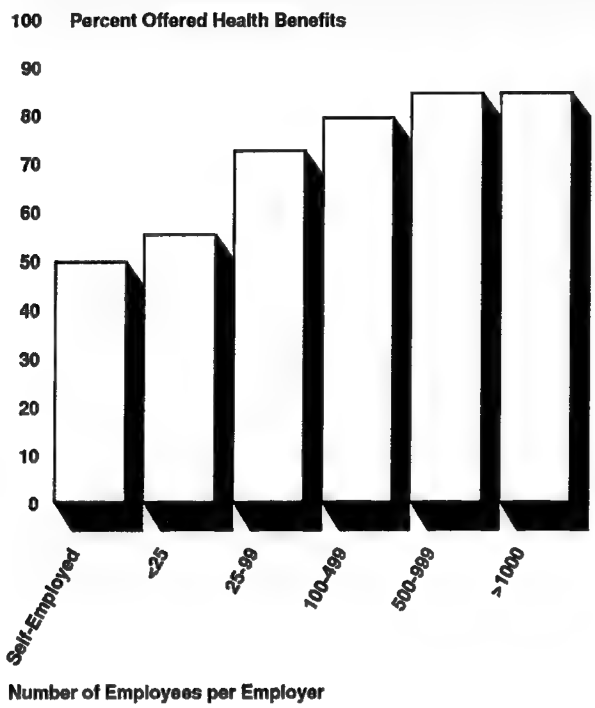
About 73 percent of the 123 million workers in the United States had employer-provided health benefits in 1989, according to CPS data. High percentages (over 90 percent) of full-time employees who worked for employers with 100 or more employees or for governmental units were offered health benefit coverage by their employers. Individuals who worked for smaller employers, employees who worked less than full time, and employees who had lower incomes generally had lower percentages of coverage.

In addition to the 89.6 million public- and private-sector workers with employer-provided health benefits, an additional 51.1 million nonworkers and children had coverage under employer plans. In total, about 140.8 million individuals—workers, nonworkers, and children—received employer-provided insurance coverage from employers. These recipients represent nearly two-thirds of the total nonelderly U.S. population.

Employer-sponsored health care coverage varies according to employer size, with larger employers generally covering a higher percentage of their employees. Figure 3.1 shows that larger employers were more likely to offer health benefits to their employees.

[2]AGI is total income minus adjustments for such deductions as IRAs, self-employed health insurance costs, Keogh retirement plans, alimony paid, and losses from business operations. Taxable income is AGI minus exemptions and such other allowable deductions as medical expenses, charitable deductions, interest and tax payments, and casualty losses.

Figure 3.1: Percentage of Workers Under Age 65 Whose Employers Provided Health Benefits, by Size of Employer (1989)



Note: Includes private- and public-sector workers.

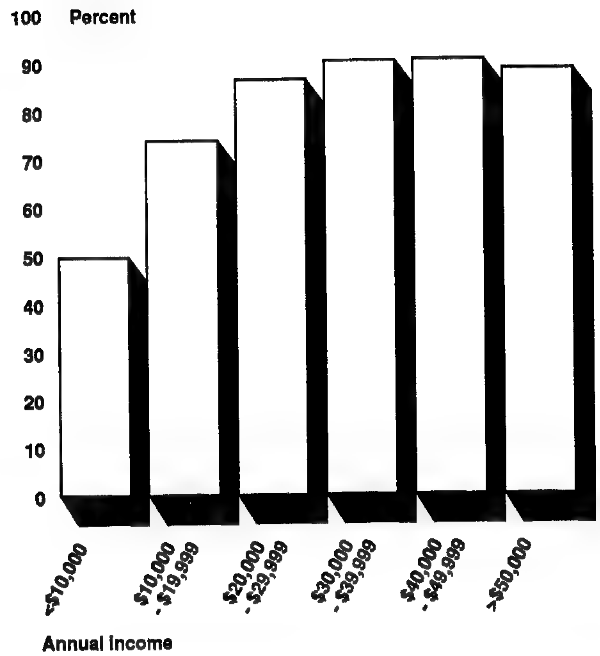
Source: EBRI tabulations of March 1990 CPS data.

In 1989, about 34.4 million of our nation's population under age 65 did not have health benefit coverage. Of these, about 85 percent were working or living in a family headed by a worker who was either a part-time, part-year,[3] or full-time employee.

Figures 3.2, 3.3, 3.4, and 3.5 are based on March 1990 CPS data for 1989. They show, by selected demographic characteristics, percentages of the population age 18 to 64 that had employer-provided health benefit coverage. Appendix I contains more detailed information on other sources of health benefit coverage for this population and the percentages of this population that did not have health insurance. As shown in figure 3.2, workers with higher total earnings were more likely to have employer-provided health coverage than lower earners.

[3]Census considers people who work full time less than 50 weeks a year to be part-year workers.

Figure 3.2: Percentage of Workers With Employer-Provided Health Benefits, by Total Earnings (1989)

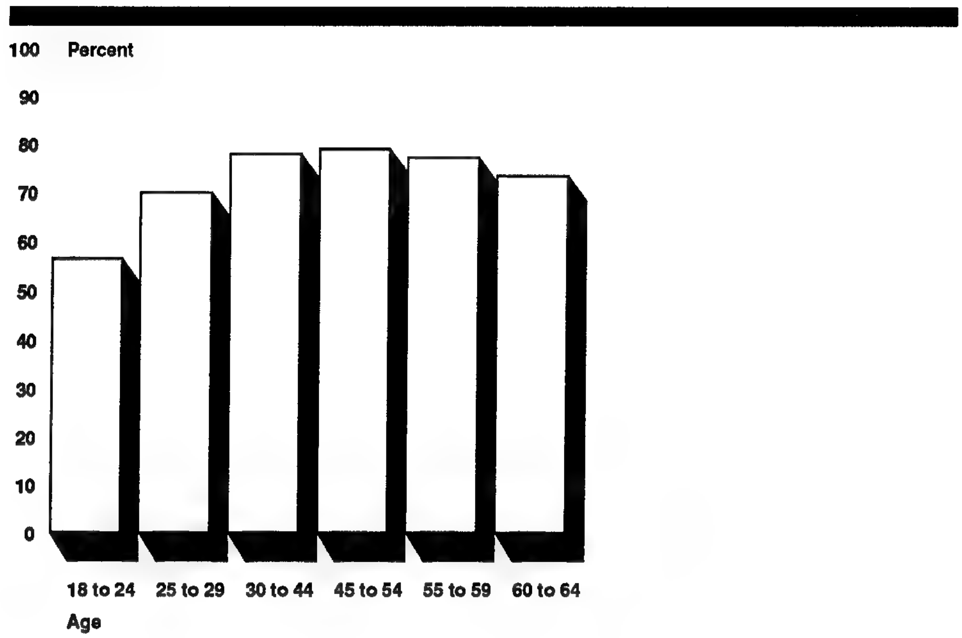


Note: Includes private- and public-sector workers.

Source: EBRI tabulations of March 1990 CPS data.

Figure 3.3 shows that individuals who were less than 29 years old were less likely than others to have employer-provided health benefits. For individuals between 30 and 59 years old, coverage percentages are about the same. At age 60, employer-provided coverage starts to decline, in all likelihood because some workers have retired and others have become disabled and therefore eligible for Medicare benefits.

Figure 3.3: Percentage of Workers With Employer-Provided Health Benefits, by Age (1989)

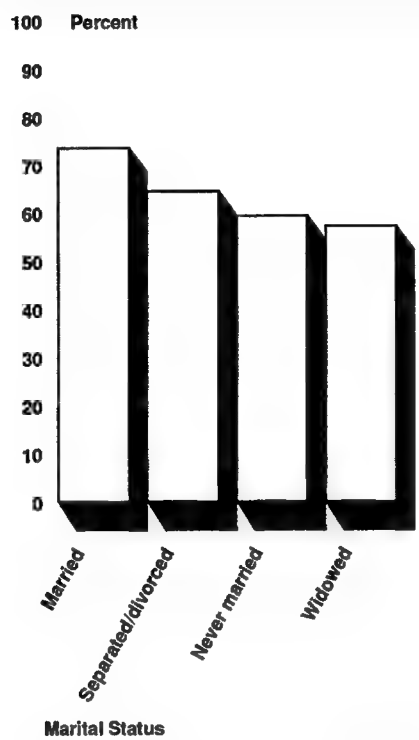


Note: Includes private- and public-sector workers

Source: EBRI tabulations of March 1990 CPS data.

Figure 3.4 shows that married workers were more likely to have employer-provided health benefits than single workers. One reason that married workers were more likely to have health benefits was that they can receive them either under a plan sponsored by their own employer or under one sponsored by their spouse's employer.

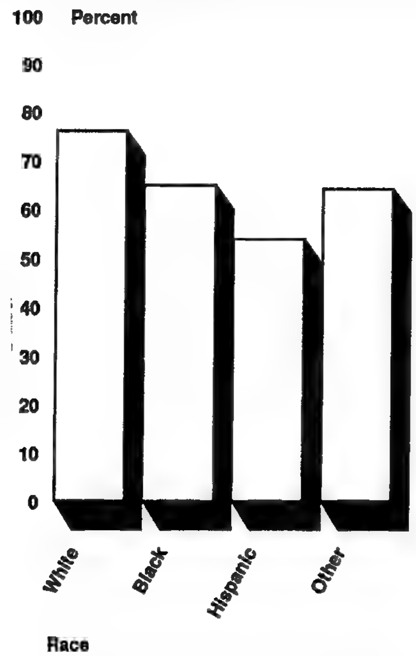
Figure 3.4: Percentage of Employees With Employer-Provided Health Benefits, by Marital Status (1989)



Source: EBRI tabulations of March 1990 CPS data.

Figure 3.5 shows that whites were more likely to have employer-provided coverage than those of other races.

Figure 3.5: Percentage of Employees With Employer-Provided Health Benefits, by Race (1989)



Source: EBRI tabulations of March 1990 CPS data.

Coverage Varies by Industry Group

As is the case with pension coverage, some industry groups are more likely to provide health benefits to their employees than others. Industry groups with relatively high rates of pension and health benefit coverage included governmental units and finance, insurance, real estate, and manufacturing firms. The retail trade and construction industries have relatively low rates of pension and health benefit coverage. The professional services industry has a low rate of pension coverage and a high rate of health benefit coverage. Table 3.1 shows, by type of industry, those with higher and lower percentages of insured and uninsured workers.

Table 3.1: Percentage of Workers With No Health Insurance Coverage, by Industry of Primary Employment (1989)

	Millions of employees	Percent of workers with no health insurance
Industries with high percentages of insured workers		
Government	18.5	6.5%
Finance, insurance, and real estate	7.3	8.2
Transportation	6.3	9.5
Manufacturing	21.7	10.1
Professional services	14.5	10.3
Wholesale	4.1	12.2
Mining	.7	14.3
Industries with high percentages of uninsured workers		
Business and repair services	6.2	21.0
Self-employed	12.1	21.4
Retail trade	18.3	22.4
Entertainment	1.1	27.3
Construction	6.2	29.0
Personal services	3.7	29.7

Source: EBRI tabulations of March 1990 CPS data.

In addition, employees who were union members or who were covered under a collectively bargained contract were more likely to have health benefit coverage than nonunion workers. In the private sector, in 1988, 91 percent of the union workers had coverage compared to 75 percent of the nonunion workers.

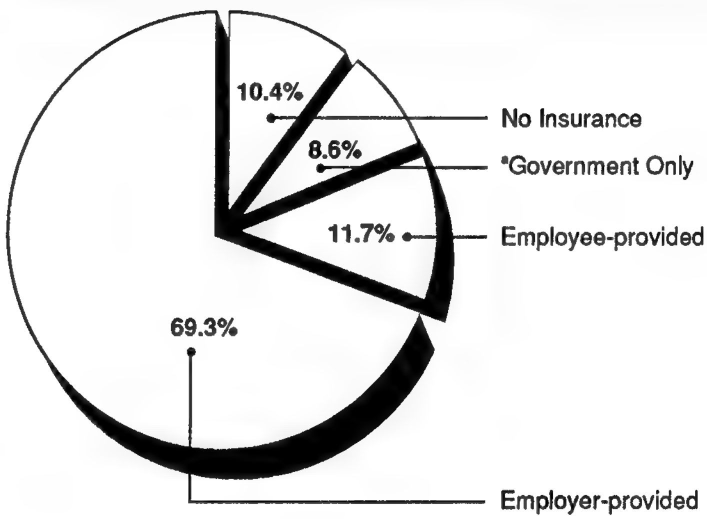
Employer-Provided Health Coverage Less Extensive for Retirees

In addition to covering most active workers in the United States, employer-provided health benefits cover many retirees. Most individuals under 65 years old are not yet eligible for Medicare coverage. Therefore, for individuals who are less than 65 years old and who are retired, employer-provided retiree health benefits can be particularly important. With several exceptions, Medicare is the primary payer of medical expenses for retirees 65 and older. Employer-provided and individually purchased health benefit coverage is intended to supplement Medicare by covering such expenses as the Medicare deductibles, costs of prescription drugs, and stays in hospitals that exceed Medicare length maximums.

While many retirees have employer-provided health benefits, most of these benefits are provided by a small percentage of our nation's employers.[4] The largest employers provided most of this coverage. In total, over 10 million of the 23.7 million retirees had these benefits, according to August 1988 CPS data.

Figure 3.6 shows that about 70 percent of the retirees who were less than 65 years old had employer-provided health benefits.

Figure 3.6: Health Care Coverage for Retirees Under Age 65 (1989)



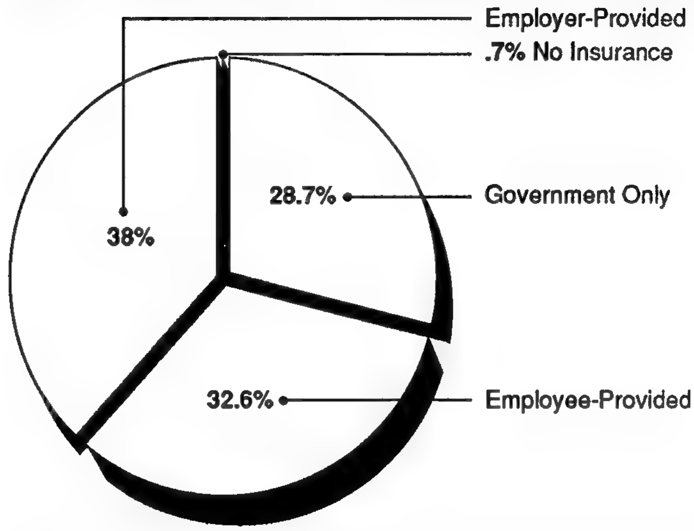
ªNote: Includes Medicare and Medicaid

Source: GAO analysis of March 1989 CPS data for individuals who indicated they were retired.

Almost all retirees age 65 and over receive government-provided Medicare benefits. Figure 3.7 shows that, in addition, employers provide health benefits to over one-third of the retirees age 65 and over and that nearly one-third of the rest of the retirees also purchased supplemental health insurance coverage for themselves.

[4] Issues related to retiree health benefits are discussed in more detail in our following reports: Employee Benefits: Extent of Multiemployer Plan Retiree Health Coverage (GAO/HRD-90-132, July 17, 1990) and Employee Benefits: Extent of Companies' Retiree Health Coverage (GAO/HRD-90-92, Mar. 28, 1990).

Figure 3.7: Health Care Coverage for Retirees Over Age 64 (1989)



Source: GAO analysis of March 1989 CPS data for individuals who indicated they were retired.

Employers that provide their employees with pension benefits generally fund these benefits in the years before an employee retires. Conversely, most employers that provide their retirees with retiree health benefits generally finance them on a pay-as-you-go basis (i.e., benefits are paid for in the year the expense is incurred).

In December 1990, the Financial Accounting Standards Board published a new accounting standard that prescribes how employers shall measure and report postretirement benefit obligations.[5] The primary objective of this standard is to improve employers' financial reporting of retiree health benefit obligations. In effect, the standard will require most employers to report these obligations as unfunded liabilities on their financial statements. In anticipating this standard, which had been under development for several years, many employers began clarifying their health benefit promises to their retirees, and some employers started scaling back these benefits. According to representatives from benefits consulting firms, before this standard starts taking effect—not later than December 1992—other employers are expected to analyze their retiree health obligations and to modify their health benefit packages for retirees.

[5]Statement of Financial Accounting Standards No. 106: Employers' Accounting for Postretirement Benefits Other Than Pensions (Dec. 1990).

Cost-Sharing and Coverage Disparities Exist Among Employers That Provide Coverage

Total average costs for health benefits (to both employer and employee) were estimated at over $3,200 per employee for family coverage and $1,400 for individual coverage, according to the Health Insurance Association of America's 1989 employer survey. A more recent private-sector survey by A. Foster Higgins—a benefits consulting firm—also showed that for over 1,400 medium-and large-sized employers that responded, total average health plan costs were over $3,200 per employee in 1990.

However, all employees do not receive the same employer-provided health benefits. Depending on the specifics of a firm's health benefit package and other factors, employers' costs for providing health benefits can vary significantly from these averages. Moreover, because the costs of these benefits depend on such factors as a firm's geographic location, industrial classification, size, and mechanism for financing health benefit programs, the costs to employees and employers can vary significantly. Other coverage differences discussed in the following sections relate to (1) comprehensiveness of benefits provided, (2) cost-sharing arrangements between employers and employees, and (3) cost-containment features that apply to health plans.

Employer Plans Vary in the Comprehensiveness of Coverage Provided

Health care benefits provided to over 90 percent of the full-time employees covered by the 1989 BLS survey included hospital coverage, inpatient and outpatient surgery, physician visits, prescription drugs, x-ray and laboratory services, and mental health and substance abuse coverage. Benefits provided to fewer employees included dental care (covering 66 percent of the participants), vision care (35 percent), routine physical examinations (28 percent), hospice care (42 percent), and home health care (75 percent).

Depending on plan specifics, medical expenses are either paid in full or subject to deductibles and coinsurance. Mental health and substance abuse expenses are usually subject to more restrictive limitations on the number of inpatient stays or outpatient visits, higher coinsurance rates, and different yearly and lifetime limits on amounts of benefits that will be paid.

Other coverage differences depend on whether the employer plan is a health maintenance organization (HMO) or a non-HMO. Over 90 percent of the participants in an HMO plan are eligible to receive hearing care, routine physical examinations, well-baby care, and immunizations and inoculation

treatments as part of their covered care compared to less than 30 percent of the participants in non-HMOs.

Differences in Health Benefit Cost-Sharing Arrangements Exist

The costs of health benefits are frequently shared by employers and employees through such mechanisms as contributions toward insurance premiums, coinsurance, deductibles, and limitations on plan benefits or on amounts paid. Depending on plan provisions, employers' and employees' shares can vary significantly.

According to the 1989 BLS survey of medium- and large-sized employers, average monthly contributions for health benefits by individuals in contributory plans were about $25 per month, ranging from less than $5 to over $80 per month. For individuals with family coverage, the average was about $72 per month, ranging from $5 to more than $200 per month. For 53 percent of the workers with individual coverage, employers paid 100 percent of the premiums; for those with family coverage, employers paid 100 percent of the premiums for 34 percent of the workers.

Over 95 percent of all full-time employees in medium- and large-sized firms with health benefits were in plans with provisions for coinsurance and deductibles. For plans with coinsurance, insurance usually pays between 80 and 90 percent of an employee's medical expenses until an individual's out-of-pocket expenses reach a fixed amount (e.g., $1,000); then 100 percent of the costs are covered. For covered individuals, about 37 percent had maximum out-of-pocket limits of less than $1,000; about 9 percent had limits over $2,000. For those with family coverage, 8 percent had limits under $1,000 and 61 percent had either a limit of over $2,000 or no limit.

The most common deductible in plans with deductibles was $100. However, over 50 percent of the participants were in plans with deductibles of $150 or more—an increase of over 500 percent since 1980. Deductibles ranged from $50 to over $300 for each insured person, and many participants were in plans that contained a maximum family deductible. Also, almost 80 percent of the participants were in plans that had maximum lifetime limits on the amounts of benefits the plans would pay. Further, about 63 percent of the participants were in plans that had limits of $1 million or more, and about 3 percent were in plans with lifetime limits of less than $100,000.

Cost-Containment Features Used to Control Health Care Costs

In trying to control their health benefit costs, employers use a variety of cost-containment measures. To the extent that employees in different plans are subject to different containment measures, health benefits received could be different. Many employees who received employer-provided health benefits were in plans with such cost-containment features as preadmission certifications, utilization reviews, second surgical opinions, higher rates of payment for mail order drugs, and incentives to audit hospital statements.

Other Factors That Can Influence the Costs of Health Benefits

Other factors that can affect amounts of employer-provided health benefits received by employees include methods of financing and delivering health benefits, the number of workers employed, the employer's geographic location, and the employer's industrial classification.

Employers have a wide variety of choices in financing and delivering health benefits to their employees. The 1989 BLS survey showed that about 36 percent of the participants were in plans that the employers had self-insured in an effort to control their insurance costs.[6] Advantages of self-insuring include gaining control over insurance reserves and an exemption from providing employees with selected health benefits mandated by state laws. The majority of employers with 1,000 or more workers self-insure.

Other choices in delivering health benefits include (1) traditional fee-for-service arrangements administered primarily by commercial insurance companies or Blue Cross/Blue Shield organizations, (2) preferred-provider arrangements, and (3) prepaid HMOs.[7]

In trying to further reduce their health benefit costs, some employers have established flexible benefit plans and flexible spending accounts[8] that allow their employees to become more involved in putting together personalized benefit packages. According to a 1990 Foster Higgins study,

[6]Issues related to health insurance costs are discussed in our report Health Insurance: Cost Increases Lead to Coverage Limitations and Cost Shifting (GAO/HRD-90-68, May 22, 1990).

[7]In fee-for-service plans, employees can select their own physician, and medical expenses are paid as they are incurred. With HMOs, employees can select their physician but choices may be limited. These organizations agree to provide a package of benefits for a fixed payment. HMOs place considerable emphasis on preventive medicine. With preferred provider organizations, employees can choose providers but pay less when services are rendered by designated health care providers.

[8]See chapter 5.

fee-for-service indemnity medical plans provided as part of an employer's flexible benefit program cost $3,181 per employee compared to $3,333 per employee for employers without these flexible benefit programs.

An advantage of flexible benefit programs is that employers can limit their costs by providing only a specific amount of benefits to each employee. In many flexible benefit programs, employers use a formula that often takes into consideration such factors as pay and tenure to establish the dollar value of flexible benefits that an employee will receive. Employees have the opportunity to decide which benefits they wish to receive by allocating these dollars among the benefits available under the program. Employees choosing health benefits can usually choose between such options as fee-for-service or HMOs.

Besides the type of health plan that a firm offers, other factors that cause disparities in employers' health benefit costs include firm size, geographic location, and industrial classification. These factors can result in different levels of benefits being provided to individuals receiving employer-provided health benefits.

For comparable plans and benefits, small firms' health benefit costs are 10 to 40 percent higher than large firms' costs.[9] A 1989 survey by the Health Insurance Association of America showed that for employers with fewer than 20 employees, individual coverage cost 9 to 15 percent more than large employers' cost and family coverage 4 to 9 percent more. However, this study did not control for differences in geographic location, benefit coverage, or health status of covered employees.

Different geographic locations can also result in different health benefit costs. The 1990 Foster Higgins study showed that average medical plan costs (both employer and employee) ranged from over $2,850 in the mountain region to $3,500 in the mid-Atlantic region.

Health benefit cost differences may also depend on a firm's industrial classification. The Chamber of Commerce's annual employee benefits survey for 1989 showed that employers' average medical cost per employee was $2,440, ranging from $2,270 for all nonmanufacturing

[9]ICF Incorporated, Health Care Coverage and Costs in Small and Large Businesses, prepared for the Small Business Administration, Office of Advocacy (Washington, D.C., Apr. 1987).

industries (retail, finance, and public utilities) to $2,825 for all manufacturing industries (chemical, transportation, textile).[10]

Tax Expenditures and Costs Related to Employer-Provided Health Benefits Are High

For 1992, Treasury estimated that tax expenditures related to employer-provided health benefits will total $33.5 billion. Table 3.2 shows tax expenditures for employer-provided health benefits for selected years since 1975. As a percentage of individual income tax revenues, this tax expenditure has more than doubled since 1975. If employer-provided health benefit tax policy does not change, the Joint Committee on Taxation estimates these tax expenditures will total nearly $50 billion in 1995.

Table 3.2: Estimated Tax Expenditures (Revenue Loss) **for Employer-Provided Health Benefits, for Selected Years**

	Tax expenditures	
Year	In billions of dollars	As a percent of individual income tax revenues
1975	$3.3	2.7%
1980	12.1	5.0
1990	21.1	6.3
1992	33.5	6.3
1995	49.5	7.5

Sources: Senate Committee on the Budget and the Joint Committee on Taxation.

In real terms, estimated tax expenditures for employer-provided health benefits increased by about 325 percent between 1975 and 1992. In general, health care expenditures have increased faster than inflation for a number of reasons, including increased national population, improved medical technology, and increased life expectancies. As shown in table 3.3, health-related expenditures as a percentage of gross national product (GNP) have more than doubled since 1960. Between 1980 and 1989, the medical care price index increased an average of 8 percent annually, whereas the consumer price index (CPI) for all items increased by an average of 4.6 percent annually.

[10]Cost includes hospital, surgical, and medical insurance premiums; dental insurance premiums; vision care; and other miscellaneous medical benefits.

Table 3.3: Health Care Expenditures as a Percentage of GNP

Dollars in billions

Year	Percent of GNP	National health expenditures	Shares of expenditures[a]	
			Employers[b]	Employees
1960	5.3%	$27.1	[c]	[c]
1965	5.9	41.6	16.6%	55.5%
1970	7.3	74.4	21.6	45.1
1980	9.1	249.1	31.4	34.9
1989	11.6	604.1	33.5	35.7

[a]Federal, state, and local governments paid most of the rest of the health expenditures.

[b]Includes private and public employers' cost for health insurance premiums, Medicare, and workers' compensation insurance.

[c]Not available.

Sources: Health Care Finance Administration, Office of the Actuary, Office of National Cost Estimates.

As shown in table 3.3, employers' share of our nation's health care expenditures has increased from about 16 percent in 1965 to over 33 percent in 1989. While the employers' share of national health expenditures has increased significantly, the employees' share of these expenditures has decreased since 1965. At the same time, individual health spending as a share of adjusted personal income has increased from 4.2 percent in 1965 to 5.1 percent in 1989—an increase of less than 1 percent.

Nineteen ninety-two estimates for other health-related tax expenditures that we did not review in detail included

- $6.7 billion for Medicare benefit coverage for which employers paid the insurance premiums,
- $3.3 billion for untaxed workers' compensation benefits received by employees, and
- $3.2 billion for medical expenses deducted by individuals.

Implications of Taxing Employer-Provided Health Benefits

As with pensions, options exist for full or partial taxation of employer-provided health benefits. While health benefits could also be taxed for revenue-raising or tax equity reasons, another reason for taxing these benefits cited by analysts could be to make the medical care system more efficient by establishing tax incentives that would reduce excessive use of the health care system. There has also been some concern that the favorable tax treatment received by employer-provided health benefits has contributed to large increases in health-care costs in recent years. Economic studies that we reviewed indicate that full taxation of health

benefits would lead to small to modest reductions in the demand for these benefits and that if health benefits were partially taxed, the effects on demand should be even smaller. The Woodbury and Huang study[11] also indicated that lower income groups may be more responsive in terms of reducing coverage than higher income groups if health benefits were taxed.

Current Tax Policy Treats Recipients and Nonrecipients of Employer-Provided Health Benefits Differently

Current tax policy discriminates against employees who do not receive employer-provided health benefits; this discrimination raises an equity issue. Horizontal inequities occur because noncovered individuals pay for health benefits with after-tax dollars, whereas covered employees with similar levels of compensation do not include the employers' share of health benefit costs in their taxable income. Even for covered workers, horizontal inequities exist because of differences in health benefits received from their respective employers. For example, some employers sponsor plans in which employees are required to pay a portion of the insurance cost, higher deductibles, or coinsurance rates.

When comparing the relatively high proportion of the labor force receiving health benefits to the proportion of the labor force participating in pension plans, horizontal equity may be of lesser concern. Yet as long as millions of individuals in the United States are without any health insurance, horizontal inequities will remain.

Vertical inequities exist when employees with higher incomes receive a disproportionate amount of tax benefits compared to those with lower incomes. Because higher income employees are more likely to have health care coverage and because they pay higher marginal tax rates than low-income earners, the tax benefits from employer-provided health benefits are greater for high-wage earners.

Employees with employer-provided health benefits are treated more favorably under current tax law than either self-employed individuals or individuals who pay all of their health expenditures with after-tax dollars. Self-employed individuals are entitled to deduct as a business expense 25 percent of their health insurance premiums from gross income. The remaining cost is considered an itemized deduction subject to the 7.5-percent limitation. Individuals who pay for health benefits with

[11]Woodbury and Huang, p. 127.

after-tax dollars and itemize their deductions may also itemize their health care costs subject to the 7.5-percent limitation. By exempting employer-provided health benefits from taxation, the government, in effect, encourages (1) employees to prefer some amount of health benefits over an equivalent wage payment and (2) employers to provide the benefit. These tax benefits are in addition to the benefits that employees receive by virtue of the fact that employers can usually purchase group health insurance at a cost that is lower than what an individual would have to pay for similar coverage.

Achieving a Balance Between Preventing Excessive Use and Providing Appropriate Care Could Be Difficult

Employers who provide health benefits to their employees could be providing "too much" in the way of health benefits. Some employees, in turn, could be overusing these health benefits, thus creating an efficiency issue. Taxing employer-provided health benefits or implementing any policy that increases employee out-of-pocket expenses could reduce overuse. However, a change of this kind could lead to some individuals forgoing timely and appropriate medical care.

Because the current tax-favored status of employer-provided health benefits effectively lowers the price of health insurance, some employees may opt for more generous coverage than they would have chosen if required to pay for these benefits with after-tax income. More expensive health insurance coverage can include lower deductibles; lower coinsurance rates; and additional coverage for such items as dental care, eye care, or drugs. The existence of health insurance in which patients pay only part or none of the expenses of using medical services could lead to more extensive use, either through more visits or more spending than would be likely if patients were responsible for the full cost of medical services.

According to both the health and labor economics literature, the purchase of health insurance is affected, from a small to a modest extent, by its tax-preferred status. Most estimates for the price elasticity of demand for health insurance are less than 1, although the estimates range from a low of .16 and to a high of close to 2.[12] An elasticity of less than 1 means that a 10-percent reduction in the price of health insurance would increase the quantity of health insurance demanded by less than 10 percent. For example, employees whose marginal income tax bracket was 15 percent would have the effective price of their health insurance reduced by 15

[12]Numbers presented are absolute values.

percent; however, they would probably buy less than 15 percent of additional health insurance compared with what they would have purchased without the tax preference.

On the other hand, employees in the 28-percent bracket receive a larger price reduction. As a result, they are likely to buy more health insurance, although less than 28 percent more. In fact, the evidence suggests that those in higher tax brackets are less sensitive to price changes than those in lower tax brackets, so the net effect on the amount of additional insurance purchased by the two groups may not be so different.

Other evidence indicated that having health insurance increases health care expenditures as a result of an increase in the number of "episodes of care" (visits to physicians or hospitals). This evidence also appeared to indicate that expenditures per episode did not increase.[13] The net effect of the tax preference for health insurance appears to be that some increased use of health care facilities occurs, but overall magnitudes are difficult to measure precisely.

A recently published study that attempted to simulate the effect of fully taxing health insurance premiums concluded that such a policy change would reduce the demand for health insurance by about 13 percent to 16 percent in low-, medium-, and high-wage industries.[14] Because price increases resulting from taxation would be greater for high-wage workers, these workers would have been expected to respond to a greater extent than low-wage workers if their elasticity was about the same. The fact that the resulting changes in amounts of health benefits purchased were somewhat similar, even though the incentive for high-wage workers was greater than that for low-wage workers, indicates that the elasticity for high-wage workers is lower than that for low-wage workers. In other words, high-wage workers are more likely to buy health insurance on their own, so they do not respond as much to tax incentives as low-wage workers who, on their own, may purchase little or no health insurance.

If health insurance premiums were to be included in taxable income, the resulting increases in the cost of health benefit coverage could lead to a reduction in the demand for health insurance. Some young and healthy people may opt to do without health insurance entirely. This

[13]Mark V. Pauly, "Taxation, Health Insurance, and Market Failure in the Medical Economy," Journal of Economic Literature, June 1986.

[14]Woodbury and Huang, p. 127.

"self-selection" could mean that those who remained insured would be, on average, older and less healthy. The likely effect is higher health-care costs for those who continue to receive the benefit. Rather than do without benefits, many workers could respond by choosing coverage that involved higher out-of-pocket expenses through higher deductibles or coinsurance rates. Efforts aimed at reducing benefit cost could provide employees with somewhat more of an incentive to use health care services in a cost-conscious way.

On the other hand, if the cost of or taxes on health benefits increased too much, disincentives to purchase health insurance or to use available benefits could result. Some employees could move from an adequate health insurance policy to one with less than adequate coverage. These same employees could suffer adverse health effects associated with not receiving timely or appropriate care. In all likelihood, individuals with low incomes or serious health problems, including those who do not earn sufficient income to pay taxes, could suffer the greatest consequences because they are least likely able to afford any increased cost as employers increase deductible and coinsurance amounts to reduce the costs of their health benefit packages. Reductions in employer-provided health benefits could be passed on to workers as higher wages, thereby providing workers with more to spend on other goods. However, to the extent that some individuals would lose access to employer-based health benefits, there could be increased pressure to expand public health care programs.

If the value of health benefits were included in taxable income, some employees could be in a better position than others to reduce this part of their income. Some employees, if their employer permitted, could elect to waive health benefit coverage entirely, particularly if they were covered by a spouse's plan. A recent article on health insurance coverage showed that in over 42 percent of the 26.4 million households with working married couples age 65 or younger, both spouses were offered employment-related health insurance.[15] Other employees might work more closely with their employers to structure benefit packages that offered wider ranges of options, including some that were less costly.

Employees in flexible benefit plans who had the option might choose lower cost health benefits that provide less extensive coverage or higher deductibles or coinsurance rates. A 1990 study of flexible benefit plans by

[15] Claudia L. Schur and Amy K. Taylor, "Choice of Health Insurance and the Two-Worker Household," Health Affairs, Spring 1991.

Hewitt Associates—a benefits consulting firm—showed that many employees had an average of six different health benefit options from which to select. The 1990 Foster Higgins study showed that in about 10 percent of the flexible benefit plans more than 25 percent of the participants chose the least expensive health benefit package available.

As discussed previously, in addition to such factors as coverage limitations, deductibles, coinsurance, and premium contributions, other factors that cause health benefits to have substantially different values include firm size and experience, geographic location, and industrial classification. When these latter-mentioned factors are present, identical benefit coverage could have substantially different costs. Thus, while including employer-provided health benefits in taxable income would generally improve tax equity, such a policy would also have differential effects that are not based on income level or tax bracket.

Options for Taxing Health Benefits Exist

While including the total value of employer-provided health benefits in an employee's taxable income is one option, CBO and others have, in the past decade, presented alternative ways to limit the tax preferences for employer-provided health benefits. Such alternatives would generally result in taxing only a portion of the benefit value. Some of the options discussed mention using tax credits or subsidies or adding revenues to finance expanded coverage for the uninsured.

CBO options for taxing health benefits include the following:

- Limiting the amount of tax-free contributions that an employer could make to an employee's health benefit plan. For example, employer contributions above $250 a month for family coverage and $100 a month for individual coverage (in 1991 dollars) would represent taxable income to employees.
- Replacing the exclusion from employee income with a limited tax credit. This approach would allow some control over the amount of tax expenditures associated with employer-provided health benefits. All employer contributions would be taxable income to employees, but employees would receive a limited tax credit for these benefits.
- Only allowing tax-free employer contributions to those plans that have at least minimal coinsurance and deductible requirements. This approach would ensure that employees bear at least some of their health care cost. For example, medium- and large-sized employers pay the full cost of health insurance coverage for over half of the workers with individual coverage and one-third of the workers with family coverage. In addition, 1989 BLS

data show that over 40 percent of the workers were in plans with deductibles of $100 or less, and 37 percent were in plans with maximum out-of-pocket limits of less than $1,000.

Options that would result in the partial taxation of employer-provided health benefits or in tax credits to offset the effects of placing a tax on these benefits would generally raise significantly less revenue than the option to fully tax health benefits. By converting the current exclusion for health benefits to a tax credit, all employer contributions would be considered taxable income, but individuals would be allowed a tax credit of, for example, 15 percent of these contributions. Because taxpayers at all income levels could receive the same credit for employers' contributions, a tax credit would reduce the current difference in subsidy rates between taxpayers in different tax brackets. The additional revenues gained from limiting the tax subsidy could be used to fund benefits for those not currently receiving employer-provided health benefits. This could be done in numerous ways, including tax credits for individual purchase of health insurance or expansion of Medicaid coverage.

Summary

Even though the breadth of health benefit coverage can vary significantly, most employees receive employer-provided health benefits. Gaps in coverage exist primarily among younger workers with lower earnings who work for smaller employers. In addition to the substantial tax preferences associated with employer-provided health benefits, health benefits provided through employer-based plans generally cost less than what individuals would have to pay for the same benefits.

Some analysts favor taxing health benefits for revenue-raising or equity reasons; others believe that employer-provided health benefits should be taxed because the tax-preferred status of these benefits has contributed to the overuse of health care services and large increases in our nation's health care costs. Still others believe that the current tax treatment of health benefits is appropriate because it encourages employers to provide this benefit to their employees.

According to the Woodbury and Huang study, the full taxation of health benefits by including the value of these benefits in taxable income would

reduce the demand for them by somewhat similar amounts for workers in high-, medium-, and low-wage industries.[16] To the extent that health benefits were fully taxed, low-income employees would generally be least able to pay increased taxes or additional health care costs resulting from the restructuring of employer-provided health benefit packages. While the taxation of health benefits could result in reduced use of some health care services, reductions in service could conceivably cause some individuals to forgo timely and appropriate medical care. However, the additional federal revenues could be used to finance targeted benefits for lower income groups most likely to be affected by these changes.

Options to partially tax health benefits have been discussed more frequently than the full taxation option. Partial taxation options would result in taxing benefits that exceed specified limits or providing tax credits to offset the effects of including the value of health benefits in taxable income. Tax credits could help reduce the difference between subsidy rates facing taxpayers in different tax brackets. Generally, these approaches would improve tax equity essentially by holding lower income groups harmless and having a greater impact on higher income taxpayers. However, to the extent that larger insurance premiums reflect higher costs of a given amount of coverage due to differences in firm size or experience, or because of the geographic location or industry of the employer, any policy change that includes these premiums in income is likely to have a differential impact unrelated to an individual's ability to pay.

[16]Woodbury and Huang, p. 127.

Limitations on Tax Preferences Available for Employer-Provided Life Insurance Benefits

Employees can receive tax-preferred, employer-provided group term life insurance with a face value of up to $50,000. The cost of more than $50,000 of this type of insurance must be included in an employee's taxable income. Treasury estimated fiscal year 1992 tax expenditures for employer-provided life insurance at $2.9 billion.

Data from BLS surveys show that 94 percent of all full-time employees who worked for private-sector employers with 100 or more employees had employer-provided life insurance benefits in 1989; 88 percent of the full-time state and local government employees had this benefit in 1990. In 1990, 64 percent of the employees who worked for employers with fewer than 100 employees also had this benefit. Self-employed individuals are not allowed to deduct the cost of life insurance from their taxable income. While life insurance provides some measure of economic protection to employees' beneficiaries in case of death, the studies we reviewed showed that the amount of insurance coverage provided can vary significantly on the basis of employer-determined factors.

Options for taxing the cost of life insurance involve eliminating the preference entirely or reducing the limit on the exclusion. If the cost of insurance were included in an employee's taxable income, those receiving this benefit from their employers would be treated the same as self-employed individuals and others who purchase life insurance with after-tax dollars. Of employees who continued to receive this benefit from their employer, older employees would face the greatest increases in taxable income because the cost of life insurance increases as they age.

Purpose and History of Employer-Provided Life Insurance Benefits

Group term life insurance that paid death benefits to survivors of deceased employees was first provided by an employer in 1911. The purpose was to protect employees' families against loss of income in time of death. In contrast to other types of life insurance products, such as "whole" and "universal" life policies, term insurance is usually purchased for a specific time period and remains in effect as long as premiums are paid. Term insurance has no savings features and no buildup of cash value. Therefore,

issues related to the tax-free "inside buildup" on fund assets do not apply to term insurance.[1] As with other life insurance products, income taxes are not assessed on benefits paid upon the death of the insured.

Group term life insurance was originally allowed as a tax-preferred employee benefit, without dollar limitation, by a 1920 IRS administrative legal opinion. According to a March 1982 Senate Budget Committee report on tax expenditures, the reason for not setting a dollar limitation was unclear but may have related to perceived difficulties in determining the cost for a particular amount of life insurance. Later studies indicated that valuation was not a problem, and the Revenue Act of 1964 (Public Law 88-272) subsequently limited the exclusion from income to the cost of life insurance with a face value of $50,000.[2] Reports accompanying the legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact in case the breadwinner were to die. According to 1979 to 1981 U.S. Life Tables, about 21 percent of the 25-year-olds will die before reaching age 65.

Employer-sponsored group term insurance usually covers a group of people working for the same employer without regard to age, sex, physical condition, or job characteristics and, even more importantly, without the need for a medical examination to document insurability. In a manner similar to pensions and health insurance, the period following World War II saw an increase in the amount of life insurance provided by employers. The face value of this insurance increased from $22 billion in force in 1945 to $48 billion in 1950. In 1988, the face value of employer-provided group term life insurance in force exceeded $2.4 trillion, according to ACLI. This insurance covered about 70 million employees and represented about 30 percent of the total amount ($8 trillion) of life insurance in force in the United States in 1988.

Table 4.1 shows for 1984 (the latest year available) the percentage of households with life insurance by household income and the median amounts of insurance provided by employers or purchased by employees.

[1]Inside buildup refers to amounts of income earned on life insurance premiums invested by insurance companies. Earnings on the investments are allowed to accumulate tax free. Inside buildup issues are discussed more thoroughly in our report entitled Tax Policy: Tax Treatment of Life Insurance and Annuity Accrued Interest (GAO/GGD-90-31, Jan. 29, 1990).

[2]This amount has not changed since enactment.

Table 4.1: Life Insurance Benefits by Type of Provider for Households With Insurance in 1984 (Dollars in thousands)

Household income	Percent of households with insurance	Median insurance amounts: Employer group life	Median insurance amounts: Individual
Under $10,000	63%	$10.0	$5.1
$10,000-$17,499	78	12.0	8.5
$17,500-$24,999	87	15.0	16.4
$25,000-$34,999	92	28.0	25.0
$35,000 and over	92	45.0	40.0

Sources: ACLI and Life Insurance Marketing and Research Association.

Employees may receive up to $50,000 in employer-provided life insurance without including the cost of the insurance in taxable income. Employer payments for the cost of insurance that exceeds $50,000 in face value must be included in taxable income. Self-employed individuals are not entitled to deduct the cost of life insurance from taxable income. To the extent that employees pay any part of the insurance cost, their payments would be credited to coverage in excess of $50,000.

For purposes of determining the cost of life insurance in excess of $50,000, Treasury regulations provide a schedule that shows the monthly cost of $1,000 of life insurance for individuals of various ages. For example, the cost of $1,000 of insurance for a 30-year-old employee is shown as $.09 per month or $1.08 per year; the cost for a 60-year-old employee is shown as $1.17 per month or $14.04 per year. IRS has used these rates since 1983.

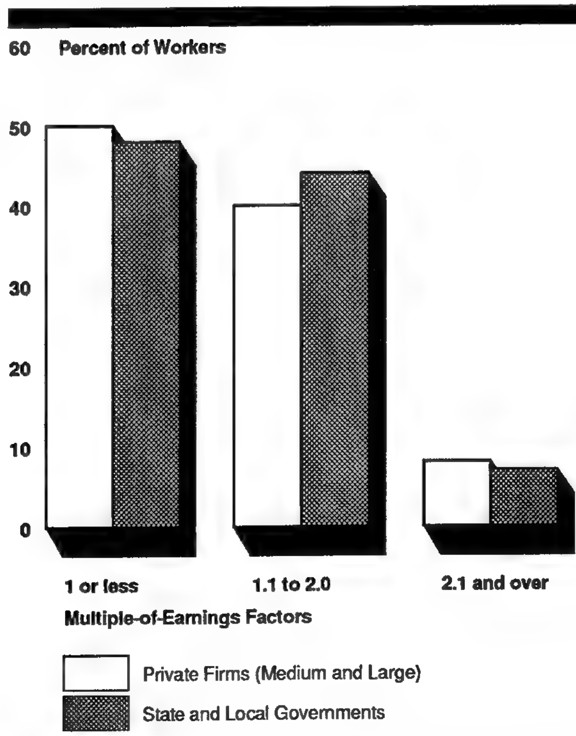
In addition to providing life insurance coverage, employers frequently provide dependents with other income-related protection against an employee's death. Employers provide this additional protection through such benefits as accidental death and dismemberment coverage, survivor income protection, or pension survivorship benefits. Also, about 42 percent of the full-time employees who worked for medium- and large-sized employers surveyed by BLS in 1989 had employers that provided, though in much smaller amounts, insurance on their dependents' lives.

Employer-Provided Life Insurance Widely Available but Face Value of Coverage Can Vary Substantially

For those employees with employer-provided life insurance benefits, the face value of insurance received was generally based on either a multiple-of-earnings factor or a flat dollar amount. According to BLS, in 1989 about 68 percent of the employees who worked for employers with 100 or more employees and, in 1987, about 45 percent of the state and local government employees with employer-provided life insurance benefits had coverage that was related to their earnings and a multiple-of-earnings factor. Nearly all of the remaining employees with coverage had insurance amounts that were based on a flat dollar amount—$10,000, for example. Under a flat dollar amount benefit, each employee with coverage receives a flat dollar amount of insurance regardless of earnings. Unlike for pension benefits, the amount of insurance received by an employee is rarely linked to length of service.

Figure 4.1 shows the percentage of workers whose life insurance amounts were based on their earnings and a multiple-of-earnings factor.

Figure 4.1: Percentage of Workers with Employer-Provided Life Insurance Based on Earnings and a Multiple-of-Earnings Factor



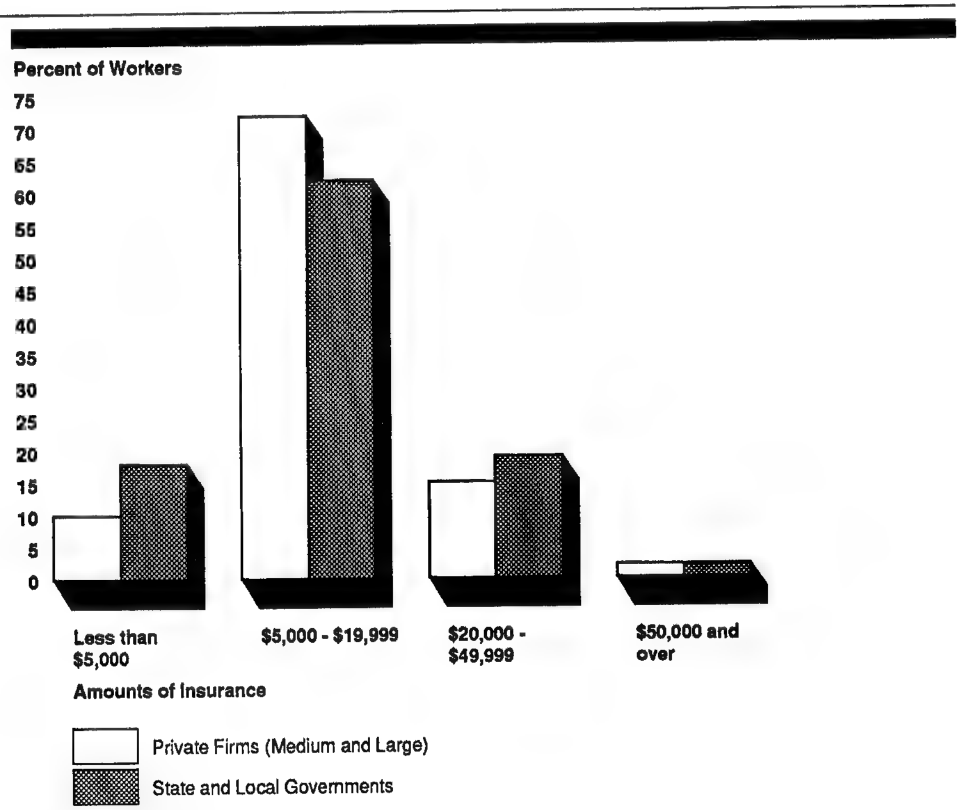
Note: Multiple-of-earnings factors times annual earnings equals earnings times 1 or less, earnings times 1.1 to 2.0, etc.

Source: BLS 1987 and 1989 surveys of employee benefits.

For full-time workers in medium- and large-sized firms, average insurance benefits closely approximated workers' salaries at all salary levels. For example, workers with 10 years of service earning annual salaries of $15,000, $25,000 and $55,000 had about $20,450, $31,850 and $58,650 of insurance, respectively, in 1989.

Figure 4.2 shows the amounts of coverage for workers with flat dollar amounts of insurance. About 31 percent of the employees with medium- and large-sized private plans and about 54 percent of state and local government employees had this type of coverage. For those with flat dollar coverage, most had employer-provided life insurance protection of less than $20,000.

Figure 4.2: Percentage of Workers With Employer-Provided Life Insurance Benefits Based on Flat Dollar Amounts

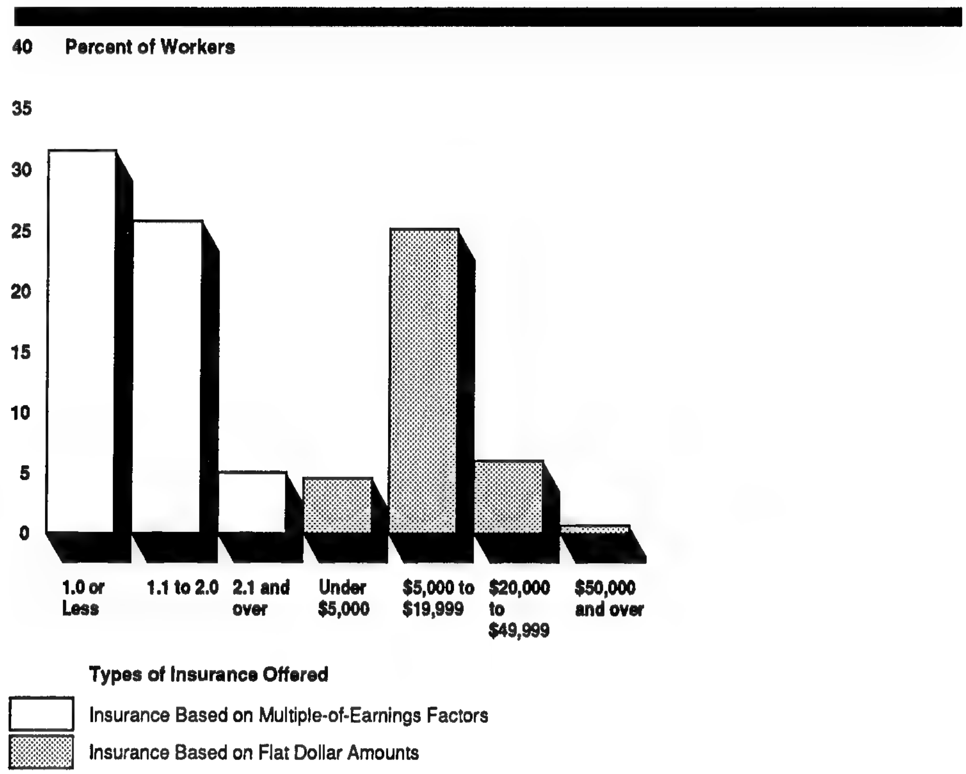


Source: BLS 1987 and 1989 surveys of employee benefits.

BLS's 1987 and 1989 employee benefit surveys of state and local governments and medium- and large-sized employers represented 39 million employees that had life insurance based on either

multiple-of-earnings factors or flat dollar amounts. Figure 4.3 shows the percentages for each type of coverage.

Figure 4.3: Percentage of Workers With Employer-Provided Life Insurance Benefits, by Type of Insurance Offered



Note: Does not add to 100 percent because some insurance amounts are calculated by other methods.

Source: BLS 1987 and 1989 surveys of employee benefits.

In addition to life insurance protection for which active workers are eligible, about 42 percent of the private-sector employees and 44 percent of the state and local government employees continued to receive life insurance protection after retirement. In most cases, however, amounts of insurance coverage provided were reduced following retirement.

Some Equity Concerns Moderated by Limitations on Benefits

Treasury's fiscal year 1992 tax expenditure estimate for employer-provided life insurance benefits was $2.9 billion. While tax expenditures for this benefit have grown steadily over the last 15 years in nominal dollars, these increases have for the most part been rather modest in real terms, especially when compared to the costs of employer-provided health insurance benefits. In 1975 and 1985, Treasury's estimated tax expenditures for group term life insurance were about $1.9 billion and $2.6 billion, respectively, in 1991 dollars.

Tax equity issues related to employer-provided life insurance parallel those raised in the previous chapters. Those in favor of taxing fringe benefits believe that both horizontal and vertical inequities result from the current tax treatment of employer-provided life insurance. To the extent that some employees have access to this benefit while others do not, horizontal inequities may result.

Because the likelihood of coverage increases with income and the value of the tax benefit increases with the marginal tax rate, vertical equity questions also exist. However, the extent of vertical inequity is somewhat limited in that (1) many covered employees have a flat amount of insurance that is independent of income and (2) the face amount of life insurance that employers can provide tax free is limited to $50,000.

Implications of Taxing Employer-Provided Life Insurance Benefits

Options for changing the way employer-provided life insurance benefits are taxed include (1) taxing all employer-paid life insurance premiums, including costs for the first $50,000 of insurance and (2) reducing the face amount of life insurance that can be received tax free to less than $50,000. The effects of including the cost of employer-provided life insurance in taxable income would fall most heavily on older workers because the cost of the benefit increases with age.

If we use IRS' 1990 schedule for determining the cost of differing amounts of insurance, we get some idea of how much an individual's taxable income might go up if the cost of insurance were included. From the schedule, we calculated the annual cost of $50,000 of insurance for a 30-year-old employee to be $54. With this amount of insurance, someone this age would find their taxable income $54 higher. On the other hand, for a 60-year-old employee, taxable income increases by over $700 per year. The 30-year-old employee in the 28-percent tax bracket would pay about $15 in additional taxes while the 60-year-old employee in the same tax bracket would pay almost $200 in added taxes. Employees with less than

$50,000 of employer-provided insurance would be taxed only on the cost of benefits actually received.

ACLI claims that the value IRS assigns as cost of life insurance is too high for older workers. ACLI told IRS that these rates, particularly for workers between 40 and 64 years old, are generally too high and should be lowered. As a justification for lowering rates for older workers, ACLI cited recent mortality improvements and the fact that more female workers—with longer life expectancies than males—are currently in the workforce. ACLI's proposal sets the cost for $1,000 of insurance for a 30 year old at $0.10 per month, slightly higher than IRS' rate; for a 60 year old, ACLI's proposed rate was $0.95 per month, 19-percent lower than IRS' rate. According to an ACLI official, Treasury is currently awaiting new mortality information that is being developed by the Society of Actuaries before determining if rate adjustments are warranted.

If IRS retains the current schedule, the additional cost imposed by taxation could offset the advantage of receiving the benefit from the employer and cause employees, particularly older ones, to privately purchase their life insurance. According to IRS, for a 60 year old, the monthly cost of $1,000 of group term insurance is $1.17, compared to the ACLI cost of $0.95 per month.

Tax on Life Insurance Could Reduce Some Employees' Desire for Coverage

Including the cost of life insurance in an employee's taxable income would affect older employees more than younger ones. Other factors that could affect an employee's incentive to receive the benefit include (1) marital or family status, (2) health status, and (3) occupation.

If life insurance costs were taxed and employers gave their employees a choice either to continue receiving insurance or to discontinue coverage, some employees would be more interested in continuing coverage than others. For example, employees with spouses and dependents would be more likely to want coverage, particularly if the employer could purchase group life insurance at a lower price than an individual could. Conversely, unmarried employees with no dependents might have little need for a benefit that increased their taxable incomes.

Another group of employees that would probably have a greater incentive to continue receiving group life insurance, regardless of tax status, are those with hazardous jobs or in poor health. Although the actual cost to employers of group term life insurance varies depending on the number of

men and women in the workforce and the occupations of those workers, IRS' schedule showing the cost of insurance is based on U.S. mortality tables that assume the workforce to be 15-percent female. As a result, even with taxation, IRS' schedule of insurance costs for individuals with higher mortality risks could be lower than the employer's actual cost to provide this insurance.

Including life insurance benefit cost in taxable income would improve tax equity between those entitled to the benefit and those who currently have to pay for life insurance with after-tax dollars. However, because the cost of life insurance depends on an employee's age, the tax effects on older versus younger individuals working for the same company could vary significantly.

Summary

Most workers who are not self-employed receive tax-preferred life insurance benefits from their employers. Life insurance benefits for a majority of workers are based on the amount of salary received. Also, over 25 percent of all workers have life insurance coverage of less than $20,000. Even though ACLI has questioned IRS' basis for valuing the cost of life insurance for older workers, these workers would see the greatest increase in their taxable incomes if this benefit were taxed. Because the maximum tax benefit that an employee can receive is limited to the cost of insurance with a face value of $50,000, equity concerns are somewhat limited when compared to the other benefits we reviewed. However, because the cost of life insurance, and thus the tax savings, increases with an employee's age, older employees would find their taxable incomes increasing by a much greater amount if the cost of employer-provided insurance were included in taxable income. With this additional cost, some employees might decide to discontinue their employer-provided life insurance coverage, leaving their beneficiaries uncovered should they die.

Flexible Benefit Plans Allow Employees to Choose Among Selected Fringe Benefits

Flexible benefit plans and flexible spending accounts provide benefits to both employees and employers. Employees who participate in these plans can select the benefits they want the most from a list of taxed benefits, such as cash, or untaxed fringe benefits, such as child care or medical, dental, life, accidental death, or disability insurance. Employers can use these plans to reduce their total compensation cost by placing dollar limits on the amount of benefits that an employee can choose.

In addition to selecting benefits, most flexible benefit plans also allow employees to make pretax contributions to flexible spending accounts that they can use to purchase child care and health care benefits that they had previously purchased with after-tax dollars. If amounts contributed to these accounts are not used for designated benefits they may be either forfeited or rebated to participants as dividends on some reasonable basis that is unrelated to claims experience. Many employers' plans consist of only a flexible spending account. Employers and employees also benefit from flexible spending accounts in that the funds placed in these accounts are not subject to payroll taxes.

From 1986 to 1989, the percentage of full-time, private-sector employees working for employers with flexible benefit plans or flexible spending accounts increased from 5 percent to almost 24 percent, according to BLS' surveys of medium- and large-sized firms. For state and local governments, about 5 percent of the full-time employees could participate in a flexible benefits program, and 31 percent could participate in a flexible spending plan in 1990. Flexible benefit plans are not available to federal employees. Tax expenditure estimates for flexible benefit plans have also increased, from $1 billion in 1987 to $3.5 billion in fiscal year 1992, according to the Joint Committee on Taxation.

Changing the tax treatment of flexible benefit plans without changing the tax treatment of other fringe benefits would, in all likelihood, have minimal effects on tax revenues and tax equity. Employers could still provide the same benefits regardless whether they were offered as part of a flexible benefits plan. However, if the tax treatment of flexible spending accounts were changed, some increased revenues and improved equity would result as employees who purchased child care and health care benefits with pretax dollars would be treated the same as individuals who purchased these benefits with after-tax dollars.

Background and Early History of Flexible Benefits

In the 1970s, several companies put together benefit packages that allowed their employees to choose which benefits they wished to receive. One of the first employers to implement a flexible benefits plan did so to meet employee needs rather than to control employee compensation cost, according to an early advocate of these plans. Employers recognized that their increasingly divergent workforces, consisting of younger and older workers, men and women, married and single people, and people with and without children, had different benefit needs.

Flexible benefit plans permit employees with different family needs to tailor their benefits to these needs. For example, in cases where both spouses work and their respective employers provide health benefit coverage, the spouse who worked for an employer with a flexible benefit plan could choose some other benefit. Other benefits that are commonly offered by flexible benefit plans include dental benefits, life insurance, and accidental death and disability benefits.

With the passage of time, employers began to recognize that they could implement flexible benefit plans in hope of controlling compensation costs, particularly health benefit costs. With flexible benefit plans, employers could implement plans that establish dollar limits on how much they wanted to spend for flexible benefits. According to a 1990 Foster Higgins report, 79 percent of the survey respondents stated that health benefit cost containment was either their primary or secondary reason for implementing a flexible benefits program.

Legislative Background of Flexible Benefits

Legislation specifically authorizing flexible benefits is in section 125 of the Internal Revenue Code, which was enacted as part of the Revenue Act of 1978 (Public Law 95-600). Several years before section 125 was enacted, Treasury had attempted, through regulations initially proposed in 1972, to require employees to include amounts contributed to salary reduction plans in taxable income. Because of the similarities between these plans and flexible benefit plans, amounts contributed to flexible benefit plans presumably would also have been included in taxable income. However, Congress enacted a series of laws that froze the tax-preferred treatment of these plans, stating that adequate study of questions related to the plans had not been possible.[1]

[1]Public Law 93-406 (ERISA), Public Law 94-455, and Public Law 96-615.

The president's tax reduction and reform proposal for 1978 indicated that the state of the law regarding the future of these plans continued to be unsettled and that depending on when the plan was established, participants' benefits under these plans received different tax treatments. The legislative history of Public Law 95-600 did not indicate whether the studies suggested by the earlier legislation had been conducted; however, a need existed to provide on a more permanent basis rules for treating these benefits.

Under the Revenue Act of 1978, flexible benefit plans must be in writing and offer choices between qualified benefits and cash.[2] Not all fringe benefits can be offered under these plans. Legislation prohibits them from offering such fringe benefits as van pooling or educational assistance. In addition, flexible benefit plans must not discriminate in allowing employees to participate in a plan. In addition, plans cannot distribute excessive benefits to selected plan participants. In receiving benefits, certain key employees may be limited in the amount of benefits they can receive from the plan. Section 125 of the Internal Revenue Code requires key employees to include the value of benefits received under the plan in taxable income if they receive more than 25 percent of the untaxed benefits provided by the plan.

Growth of Flexible Benefit Plans

In 1989, about 24 percent of the 32.4 million full-time employees who worked for medium- and large-sized firms were eligible to participate in flexible benefit plans or flexible spending accounts, according to BLS. For 1986, 5 percent of the 21.3 million employees who worked for employers that BLS studied were eligible. For state and local governments, BLS estimated that 5 percent of the full-time employees were eligible for flexible benefit plans, and 31 percent were eligible for flexible spending accounts in 1990. Neither flexible benefit plans nor spending accounts are available to federal employees.

Table 5.1 shows the benefits most frequently offered by employers that responded to private benefits consulting firm surveys.

[2]Qualified benefits include health plans, group term life insurance, disability benefits, employee contributions to 401(k) plans, dependent care assistance, vacation days, and group legal services. Benefits that are not allowed under section 125 include van pooling, educational assistance programs, employee discounts, scholarships, and certain other fringe benefits.

Table 5.1: Flexible Benefits Offered by Private Employers That Responded to Benefit Surveys

	Private consulting firm		
	Hewitt Associates (1990)	A. Foster Higgins (1990)	The Wyatt Company (1988)
Number of employers	335	274	431
Benefits offered			
Medical	97%	90%	85%
Dental	88	82	77
Life insurance	82	83	62
Accidental death and disability	62	72	48
Long-term disability	56	67	41
Vacation trading	25	19	20
401(k)	23	30	39
Vision	23	24	19
Short-term disability	13	24	11
Flexible spending accounts	95	87	65

Sources: Benefits consulting firms.

Some flexible benefit plans consist entirely of stand-alone spending accounts. Flexible spending accounts are usually funded by reducing employees' pretax salaries. Unspent funds in the account at the end of a plan year may be forfeited or rebated to participants as dividends on some reasonable and consistent basis that is unrelated to claims experience. The 1989 BLS survey of medium- and large-sized employers showed that 62 percent of the employees worked for employers that had stand-alone accounts.

For plans with flexible spending accounts, average percentages of employees choosing to receive benefits and average contributions to these accounts are shown in table 5.2.

Table 5.2: Participation in and Contributions to Flexible Spending Accounts by Employers Responding to Benefit Surveys

	Private consulting firm			
	TPF&C[a]	Hewitt Assocs.	A. Foster Higgins	Wyatt Company
Number of plans offering lexible spending accounts	255	428[b]	499[b]	800[c]
Participation rates				
Health benefits	18%	18%	19%	22%
Child care	3	3	4	7
Average contributions				
Health benefits	$488	$594	$608	$500
Child care	2,504	2,696	2,555	2,000

[a]TPF&C (a Towers Perrin company).

[b]Not all employers provided information on participation rates and contribution amounts.

[c]Estimated.

Sources: Benefits consulting firms.

Flexible spending accounts are particularly useful to employees because they can use the funds placed in these accounts to pay medical expenses not covered by their health care plan or to pay deductibles or coinsurance amounts that would otherwise be paid for with taxable dollars. In these cases, flexible spending accounts could be defeating an important purpose of deductibles and coinsurance, which is to make employees pay a portion of their medical expenses, thereby inhibiting excessive use of the health care system. Furthermore, rather than forfeiting unspent amounts in flexible spending accounts, employees could be encouraged to purchase additional medical services or supplies that would not normally be covered by their employers' health care plan.

Tax Expenditures Related to Flexible Benefits

The Joint Committee on Taxation estimated that tax expenditures for flexible benefit plans will increase from $1 billion in 1987 (less than 0.3 percent of individual income tax revenues) to $3.5 billion in fiscal year 1992 (about 0.6 percent of individual income tax revenues). According to Committee staff, much of this increase can be attributed to the growth in the number of employers offering these benefits. Neither Treasury nor CBO currently prepares tax expenditure estimates for these plans. According to Treasury officials, their tax expenditure estimates for other fringe benefits in effect includes amounts for flexible benefits. In other words, the tax expenditure estimate for employer-provided health benefits includes an amount for health benefits provided through flexible benefit plans and flexible spending accounts.

Implications of Taxing Flexible Benefits

Fully taxing flexible benefits that do not include flexible spending accounts without taxing other fringe benefits would appear to have little effect on tax expenditures. Employers could restructure their benefit packages to provide the same benefits that were provided under their flexible benefits plan. More important than the issue of taxing the value of flexible benefits received is the issue of the tax treatment of flexible spending accounts. Employees who have the opportunity to participate in flexible spending accounts can contribute pretax dollars to these accounts, thereby reducing their taxable income to purchase benefits that would otherwise be purchased with after-tax income. As a result, from a tax standpoint, the opportunity to participate in these accounts provides some individuals with greater tax benefits than those that only participate in a flexible benefits plan without a flexible spending account.

CBO, in its options for reducing the federal deficit, has discussed changes in the tax treatment of flexible benefit plans and flexible spending accounts. Moreover, IRS and Congress have periodically expressed concern about the growth of tax expenditures related to these plans and accounts. They were concerned that these plans and accounts had the potential for (1) eroding income and payroll tax bases and further shifting a disproportionate tax burden to those individuals whose compensation is in the form of cash wages and (2) contributing to the overuse of health care services by allowing employees to pay deductibles and coinsurance with funds from flexible spending accounts.

Options for taxing flexible benefits have called for (1) repealing the legislative provisions for these plans while maintaining the current tax status of the other fringe benefits and (2) requiring employees to include in income the value of flexible benefits that exceeds an established minimum. Although flexible benefit plans could promote economic efficiencies by not forcing employees to receive fringe benefits that they cannot use, CBO stated that this improvement in efficiency would be achieved at the cost of removing compensation from the tax base.

In 1987, the House of Representatives passed legislation that would have limited the amount of benefits that an employee could receive tax free under a flexible benefits plan. If an employee had an option of receiving cash or benefits worth more than $500 under the plan, the amounts received over $500 would be taxed even if the employee did not select the cash. The Senate did not act on this proposal, and it died in conference.

Summary

Flexible benefits plans and flexible spending accounts are a relatively new addition to employers' compensation packages. Since 1986, the number of full-time employees who worked for medium- and large-sized firms that had implemented these plans and accounts has increased significantly.

Many employers implemented these plans and accounts to contain overall compensation costs while still offering their increasingly divergent workforces choices among which benefits they wished to receive. Flexible benefit plans also provide some employees, such as working spouses, with opportunities to more efficiently meet their benefit needs. One option for taxing flexible benefits would limit the amount of tax-free benefits that employees could receive annually. While implementation of this option might stem the growth of these plans, it could have little effect on tax equity or revenue, particularly if employers subsequently provided benefits offered under these plans as they did in the past. In some respects, even if flexible benefits were taxed, the use of these plans would probably continue to increase as more employers use them to control their compensation costs while meeting the benefit needs of their employees.

Taxing employee funds designated for flexible spending accounts would eliminate the tax advantages of such accounts. Income tax and payroll tax revenues would be expected to increase because child care and health care benefits that employees had been purchasing with pretax dollars would have to be purchased with after-tax dollars. If workers with higher incomes are currently receiving a disproportionate amount of flexible benefits, taxation of these benefits would further improve tax equity.

Implications of Changing Employee Benefit Tax Policy

Including nonwage fringe benefits in taxable income in the same manner as income from salaries and wages would represent a major change in employee benefit tax policy. Additional tax revenues raised as a result of such a change could be used to reduce the deficit or lower general income tax rates. Alternatively, increased tax revenues could be either (1) offset by tax credits aimed at achieving benefit equity among benefit recipients or (2) used to establish programs to meet medical expenses, retirement income, or other needs of individuals who do not receive fringe benefits.

Full taxation of fringe benefits at the individual level could increase employees' income taxes significantly and reduce tax expenditures. Older employees would be affected greatly because of the manner in which life insurance and pension benefits are generally valued. Also, to the extent that coverage and marginal tax rates increase with income, workers with higher incomes would pay more taxes than those with lower incomes. However, a recent Woodbury and Huang study seemed to indicate that there could be disproportionate reductions in lower income employees' benefit coverage if benefits were taxed.[1] To the extent that employees lose their access to employer-provided benefits, increased pressures to establish public programs to meet these employees' benefit needs could develop.

In an attempt to maintain some of the societal benefits generated by the tax preferences, as well as to mitigate the impact of full taxation of benefits, several alternatives have been presented. Caps or limitations in addition to those that already exist could be placed on the amount of fringe benefits that employees could exclude from taxable income. The value of the fringe benefits could also continue to be excluded from income for payroll tax purposes, thus providing some tax relief to both employers and employees. Another way of mitigating the impact on lower income employees could be to establish tax credits that would offset the impact of including the value of benefits in taxable income or to place an excise tax on employers that could be based on the value of benefits provided.

In many respects, reactions to proposals to tax employee benefits are already known. Policymakers have generally looked to employers to lead the way in expanding health and retirement benefit coverage. In the past, it was hoped that employers would voluntarily increase coverage; more recent discussions have focused on government mandates that could require employers to provide benefits. Any effort to tax fringe benefits, in

[1]Woodbury and Huang, p. 140.

and of itself, is likely to reduce coverage and benefits and, as such, runs counter to congressional and executive branch efforts to expand coverage, particularly for such benefits as pensions and health. However, the revenues generated from taxing the benefits could be used, in whole or in part, to provide additional coverage through direct spending or subsidies.

While the benefits we reviewed comprise perhaps the most important ones offered by employers, we recognize that many other tax-preferred benefits exist.[2] In our opinion, any change in employee benefit tax policy would need to consider the extent to which these other benefits should be included under the umbrella of change.

Including Fringe Benefits in Taxable Income Affects Older Workers and Those in Highest Tax Brackets the Most

Table 6.1 shows how employees of different ages and incomes might be affected by changes requiring that benefits be included in an individual's taxable income. For this example, employees received the same benefits after a hypothetical change in tax policy. As will be discussed later, changes in tax policy would in all likelihood result either in changes in employee benefit packages or in the selection of different benefits by employees. Table 6.1 does not reflect these changes.

[2]Other tax-favored fringe benefits include employee discounts; working condition benefits (demonstration cars, meals, athletic facilities); child care facilities; and group legal services.

Table 6.1: Effects of Including Benefits in Hypothetical Employees' Taxable Incomes

	Employees			
Employee assumptions	**A**	**B**	**C**	**D**
1. Salaries	$25,000	$25,000	$60,000	$60,000
2. Ages	30	60	30	60
3. Years of service	5	35	5	35
4. Taxable incomes	$17,000	$17,000	$45,000	$45,000
Benefit assumptions				
5. Defined benefit pension plan	$210	$8,155	$500	$19,575
6. Health benefits[a]	2,000	2,000	2,000	2,000
7. Life insurance[b](two times salary)	55	700	55	700
8. Flexible benefits[c]	500	500	1,200	1,200
9. Total benefit value	$2,765	$11,355	$3,755	$23,475
10. Taxable income (total lines 4 and 9)	$19,765	$28,355	$48,755	$68,475
Increase in estimated tax				
11. 15-percent rate	$415	$1,703	[d]	[d]
12. 28-percent rate	[d]	[d]	$1,051	$6,573
13. Total equivalent income (lines 1, 9, and 11 or 12)	$28,180	$38,058	$64,806	$90,048

[a]For this example, we did not consider age or health status in establishing the value for this benefit.

[b]On the basis of current law, employees C and D would have included the costs of life insurance in excess of $50,000 in their taxable incomes. Using IRS'schedule, the extra $70,000 of insurance costs about $75 for a 30 year old and $980 for a 60 year old and should already be included in taxable income. If the cost of the first $50,000 of insurance is also included, taxable incomes would increase by the amounts shown in the table.

[c]Based on 2 percent of salary.

[d]Not applicable.

As shown in table 6.1, taxable incomes increase significantly as employees near retirement. As discussed previously, the value of pension and life insurance benefits generally increases substantially with age. The information on estimated taxes at the bottom of table 6.1 also illustrates the extent to which older workers benefit from the current tax treatment of fringe benefits. Of course, taxes on pensions that applied not to individuals, but to the fund, may not have this same differential effect on older workers.

If the employees in table 6.1 participated in defined contribution plans that paid the same retirement benefits as those paid by the defined benefit plan in the example, the increases in their taxable incomes would be higher when they were younger and slightly lower as they neared retirement.

Table 6.2 shows how pension benefits earned differ between defined benefit and defined contribution plans with the same present value of accrued benefits at retirement.

Table 6.2: Differences in Pension Income Between Defined Benefit and Defined Contribution Plans for Hypothetical Employees

	Employees			
	A	B	C	D
Salary	$25,000	$25,000	$60,000	$60,000
Age	30	60	30	60
Defined benefit plan				
Increase in taxable income	210	8,155	500	19,575
Defined contribution plan				
Contributions based on salary	$1,261	$1,261	$3,025	$3,025
Earnings on plan assets	650	6,201	1,560	14,884
Increase in taxable income	$1,911	$7,462	$4,585	$17,909

In these examples, employees would be responsible for the increased taxes. Moreover, if applicable payroll taxes were also collected on increases in gross income, employers as well as employees could be faced with further increases in their tax expenses. Table 6.3 shows the effects of including the value of fringe benefits in gross income for payroll tax purposes.

Table 6.3: Effects of Including Benefit Costs in Hypothetical Employees' Payroll Tax Bases

	Employees			
	A	B	C	D
Employee characteristics				
Salary	$25,000	$25,000	$60,000	$60,000
Age	30	60	30	60
Total increase in benefits (from table 6.1)	$2,765	$11,355	$3,755	$23,475
Payroll tax increase				
Employee share	$211	$869	$54	$340
Employer share	211	869	54	340
Total increase	**$422**	**$1,738**	**$108**	**$680**

For this table, we calculated increases in payroll taxes on the basis of 1991 payroll tax rate of 15.30 percent on earnings, with employers and employees each paying equal shares. For each share, the Social Security

retirement portion is 6.20 percent of earnings up to $53,400, and the Medicare portion of the tax is 1.45 percent of earnings up to $125,000.

While total employer and employee payroll taxes are greater for higher income employees, payroll tax increases would be greater for employees who earn less because these employees have not reached the earnings ceiling of $53,400. For these employees, the Social Security retirement portion of the tax is applied to the full value of benefits earned. Individuals already at the earnings ceiling for retirement benefits, as in table 6.3, would have to pay the Medicare portion of payroll taxes on earnings up to $125,000.

An increase in payroll taxes would increase the current surplus in the Social Security Trust Fund. However, because some employees would have higher income bases upon which their Social Security benefits would be computed, future Social Security liabilities would increase. Increasing employees' taxable income could also affect employees who live in states that have state or city income taxes that are based on gross income or on amounts of federal taxes paid. Unless exceptions were made, workers in states with income taxes would have greater tax burdens than workers in states with low or no income taxes. In addition to the concerns related to increases in employees' taxable incomes and payroll taxes if fringe benefits were to be taxed, provisions for tax withholdings would also need to be developed.

Full Taxation Would Result in Fewer Benefits Provided

If fringe benefits were fully taxed, the total amount of benefits provided to employees would, in all likelihood, decrease. The economics literature provides some indication of the effects a tax on benefits would have on the amounts of fringe benefits demanded by employees and provided by employers.

Woodbury and Huang estimated that full taxation of pension and health insurance contributions would reduce the demand for pensions by almost 40 percent and the demand for health insurance by about 12 percent.[3] For pensions, the reduction would be substantially larger for low-wage industries than for high-wage industries while for health insurance, high-wage industries would be slightly more affected. In all cases, the response rate would be larger for low-wage industries than for high-wage industries. However, because the price increase depends on the marginal

[3]Woodbury and Huang, p. 140.

tax rate, which is higher for high-wage industries, the reduction in quantity demanded could be larger even if the response rate (elasticity) were lower.

Most of the economics literature on employee benefits treats fringe benefits as substitutes for wages and salaries. Under this approach, employers are less concerned about the form of compensation paid to their employees than about total amounts of wage and nonwage compensation paid. Therefore, if the burden of a benefit's tax were to fall on employers, they would likely be inclined to reduce either wages or benefits to control total compensation costs. If the burden of the tax were to fall on employees, they could exert pressure to receive more compensation in the form of wages rather than fringe benefits. Woodbury and Huang estimated that taxing both pensions and health insurance contributions could lead to a 3.4-percent increase in wages.[4]

Besides providing fringe benefits because of the tax preferences associated with them, employers provide these benefits to be competitive in the labor market. Also, some employers provide certain fringe benefits out of concern for their employees' welfare or to reduce expensive employee turnover, rather than because employees desire benefits. If employees were required to bear the burden of the tax, some employees might prefer receiving wages instead of benefits. However, in this case, employers might still continue providing the benefit rather than substituting equivalent wages.

Regardless of the type of tax imposed, we would expect employees and employers to work together in designing fringe benefit packages that would best satisfy each of their needs while minimizing the effects of a new tax. For example, in the case of health benefits, employers can generally provide them to employees at a lower cost than employees would pay on their own for the same coverage. Therefore, rather than purchase health insurance as individuals, employees may prefer to remain in an employer group even if premiums are taxed. Also, a number of alternative vehicles for individual savers exist that could substitute for employer-provided pension funds, especially for upper-income workers.

Alternatively, if only some employee benefits were taxed or if different tax rates applied to different benefits, employers and employees could be inclined to substitute tax-preferred benefits for taxed benefits, or benefits with lower rates for benefits with higher rates. If employers see fringe

[4]Woodbury and Huang, p. 140.

benefits as substitutes for wages and salaries rather than as supplements to them, employees might attempt to work out agreements whereby wages and salaries would be substituted for taxed fringe benefits.

Whether benefits are taxed or not, continued growth in the number of flexible benefit plans would be expected. Many employers implement these plans in hopes of containing their benefit costs. Employees seem to like them because they can select the benefits that best meet their needs. If the costs of benefits were included in taxable income, employees whose employers did not offer flexible benefit plans could be disadvantaged from a tax perspective because they might be paying taxes on benefits they neither desired nor used.

Alternative Methods of Taxing Benefits Could Have Less Effect on Coverage

The impact on benefit coverage of including fringe benefits in taxable income could be mitigated by less drastic reform. More modest approaches for raising revenues and improving tax equity have been analyzed by CBO and include such alternatives as (1) placing limits on amounts of benefits that employees could receive tax free, (2) allowing tax credits to give incentives to take compensation in the form of fringe benefits that are not dependent on the marginal tax rate, and (3) imposing excise taxes on employers on either their fringe benefit costs or on financial transactions involving such benefits as pensions.

Limits on Tax-Free Benefits

Limits already exist on the amounts of pension and life insurance benefits that employees can receive tax free.[5] Limits for these benefits could be further reduced, or limits could be extended to other benefits. For example, if limits were placed on health benefits, costs in excess of $100 per month for individual coverage or $250 per month for family coverage could be included in an employee's taxable income. For this approach, taxes for those with benefits below the limits would not increase while most of those who earn benefits that exceed the limits would be taxed.

An option included in the Woodbury and Huang study simulated the effect of a $1,125 per year cap on tax-free health insurance premiums.[6] Such a cap would reduce the demand for health insurance by about 7 percent. However, in this case, the reduction would be substantially larger for

[5]See pp. 29 and 80.

[6]Woodbury and Huang, p. 134.

workers in high-wage industries than for those in low-wage industries. In fact, workers in low-wage industries would be affected very little because their health benefit coverage, on average, tends to be lower. This result implies that caps could improve vertical equity. However, because the cost of identical health care packages varies by region and industry, the cost of packages that exceed established limits could result in higher taxable incomes for employees who live in areas of higher medical cost or who work in more hazardous industries. Thus, while vertical equity might be improved, this policy could have differential effects on individuals in similar circumstances.

Rather than establish limits on the amount of each benefit that an employee could receive tax free, the tax law could be changed to establish a limit on the total value of all fringe benefits that could be provided tax free to employees. From the government's perspective, such limits could provide a measure of control over tax revenues forgone while allowing employers and employees some measure of flexibility in deciding which benefits to offer and which to receive. Employers could benefit to the extent that limits reinforce their own attempts at containing total compensation costs.

Employees who would seem to be the most affected by limitations include those who (1) work for employers that provide a full range of fringe benefits, (2) earn higher incomes, and (3) are closest to retirement. In cases in which employees can choose among various benefits with different costs, some employees might look to manage potential increases in taxable income by being more selective in their choice of benefits.

Credits Could Reduce Some Vertical Inequities

One source of vertical tax inequity is the difference in marginal tax rates for people with different incomes. A mechanism that could reduce this difference is a tax credit equal to a percentage of the value of the fringe; thus, the percentage tax saving would be the same for every taxpayer. Employees would include the value of fringe benefits in taxable income but then apply a credit to their taxes owed equal to the given percentage times the value of the benefits received.

For example, if the credit were 15 percent, all taxpayers would be allowed to reduce their taxes by 15 percent of the value of fringe benefits. Because taxable incomes would be higher by the amount of fringe benefits, someone in the 15-percent tax bracket would be in the same position with this system as they are in the current system with fringe benefits not included in taxable income. An employee in the 28-percent bracket would

also get a 15-percent credit. As a result, the employee in the higher tax bracket would actually be paying a tax equivalent to about 13 percent of the fringe benefit value. However, for a given dollar value of fringe benefits, both would get the same tax savings—15 cents on the dollar.

If all fringe benefits were taxed, equity could be substantially improved. In our example in table 6.1, employees A and B would have no increase in tax liability while employees C and D would pay $488 (13 percent of $3,755) and $3,052 (13 percent of $23,475) in additional taxes. In addition to improving equity, the tax credit approach is likely to reduce benefit coverage less than the full taxation of benefits. Because tax credits give a similar price reduction to everyone, regardless of tax bracket, those in the higher tax brackets, who are least likely to reduce their coverage in response to price increases, would see the largest increases in their health insurance costs.

Using tax credits rather than allowing exclusions of, or imposing caps on, fringe benefits has the advantage that the tax benefit does not depend on the marginal tax rate. As a result, this source of vertical inequity is removed. Such a proposal, however, would not raise nearly the amount of revenue that full taxation of health insurance premiums would raise. CBO estimated that substituting a tax credit of 20 percent for the current exclusion would raise about $16.6 billion in additional tax revenues from 1991 to 1995 compared with about $133 billion if all employer-paid health benefits were taxed.

An additional limitation to the tax credit option is that it is best suited to those benefits that are currently not taxed at all, such as health and life insurance and flexible benefits, as opposed to those for which taxation is merely postponed, such as pensions. Currently, pension contributions and earnings are excluded from tax at the applicable marginal rate but are taxed at the relevant rate applying when pension income is distributed. If a credit were provided for some percentage of pension contributions and interest, it is not clear how the income distributed should be taxed. Consistency might argue for taxing distributions at the same percentage rate as the credit rate. However, this approach could lead to taxing the pension income of high-income taxpayers at much lower rates than the rest of their income. Alternatively, if the current system of taxing distributions is maintained, distributions might be taxed at a substantially higher rate than the credit rate on contributions and earnings. For example, someone who is in the 31-percent bracket upon retirement may have only received a

15-percent credit on contributions and earnings during his/her working life.

Employer-Based Taxes on Employee Benefits

An alternative to placing the tax burden on employees would be to tax employers on fringe benefits. In addition to the excise taxes on pension fund stock transactions we discussed in chapter 2, other options for taxing employers included (1) placing a small excise tax on the value of all fringe benefits and (2) disallowing some portion of the deduction for fringe benefits from employers' taxable incomes.

Under one option for raising revenues discussed by CBO, employers could pay a small excise tax (3 percent) on nonretirement fringe benefits provided to their employees. According to CBO, a major advantage of this type of tax is that the costs of specific benefits would not have to be attributed to individual employees. While it may be relatively easy to determine the per-employee value of employer-paid health and life insurance, values of such other employee benefits as free parking, employee discounts, child care, and recreational facilities are more difficult to determine. If excise taxes were imposed on employers rather than adding the values of specific benefits to individuals' taxable incomes, employers could reduce their administrative expenses. Employers would not have to calculate increases in employees' taxable income, nor would they have to collect payroll taxes on these benefits.

Another approach, similar to an excise tax, would be to disallow some portion of the employers' deduction from their taxable incomes. The effect of such a policy change would be to tax a portion of the employees' fringe benefits at the statutory corporate rate of 34 percent. Like the tax credit approach, this approach would reduce the vertical inequity that results from marginal tax rates that rise with income. However, it does so at the expense of taxing fringe benefits at a rate that ranges from substantially above to slightly above individual tax rates. For example, for that portion of the fringe benefits that an employer could not deduct as a business expense, employees in the lowest tax bracket would, in effect, be taxed at a rate 19-percent higher than their own marginal rate (34 less 15 percent), assuming that employers could pass the costs of fringe benefits on to their employees.

However, because (1) all companies do not pay taxes at the same rate and (2) many employers, including nonprofit and state and local government organizations, do not pay any federal income taxes, employees who work

for companies or organizations that pay lower rates or no taxes would, in effect, be receiving greater tax subsidies than those who work for companies that pay income taxes. The primary advantage of this approach is its administrative simplicity. Unlike other methods of taxing fringe benefits, this method would require no calculations of the amount of benefits each employee earned, and it would not require employees to include these benefits in their taxable incomes.

Conclusions

Since the enactment of the Internal Revenue Code, Congress, through the use of tax preferences, has generally encouraged employers to provide fringe benefits to their employees. These benefits, the most significant of which are pensions and health benefits, are important to the well-being of society because they assist large portions of our nation's workforce by supplementing their retirement income and paying most of their medical expenses. As a general rule, recipients of fringe benefits are more likely to be full-time workers, work for larger employers, and partake in more benefits as their incomes increase.

Important as fringe benefits are, the fact that two of the three largest tax expenditures are for fringe benefits makes them attractive targets to those who have an interest in either reducing the federal deficit or lowering individual tax rates. Analysts have also questioned tax inequities between fringe benefit recipients and nonrecipients and between high- and low-income employees receiving these benefits. Some analysts also believe that the favorable tax treatment received by employer-provided health benefits has contributed to the excessive use of health care services and increases in national health expenditures as a share of national income.

While full taxation of fringe benefits at the individual level could raise substantial tax revenues and could bring about the most improvements in tax equity, some employees—particularly those closest to retirement—would see disproportionate increases in their taxable income. Approaches such as taxing the pension fund rather than the individual, which would reduce the effects on particular employees, would also not improve equity as much.

According to the economics literature on health and pension benefits, the taxation of fringe benefits would cause some reduction in the demand for benefits, with pension benefits being affected more than health benefits. Although wages eventually could increase as benefit demand is reduced, employees could see, at least initially, increases in their taxable income

without corresponding increases in cash wages. In addition, because some employers could reduce the size of their health benefit package, lower income employees with less discretionary income could be more adversely affected by this type of change than employees who earned more. To the extent that these reductions leave individuals either with fewer benefits or without benefits, pressure on governmental agencies to replace the benefits could occur.

Options to partially tax fringe benefits would have more moderate effects on taxpayers. These options would generally limit amounts of fringe benefits that could be received tax free, provide taxpayers with tax credits to offset the effects of including the value of fringe benefits in taxable income, or require employers to pay excise taxes on benefits provided to their employees.

Partial taxation options would raise less revenue than those that would fully tax fringe benefits. Depending on how a partial taxation option was structured, it could result in significant improvements in tax equity. For example, tax credits to individual taxpayers would result in more equity improvements than a small excise tax paid by employers on the value of benefits provided. In addition, at least for health and life insurance and flexible benefits, the effect on coverage is likely to be minimal. This minimal effect would occur because the credit can be designed to hold harmless those in lower tax brackets while taxing at least some of the benefits of those in higher tax brackets, who are more likely to purchase coverage without the benefit of a subsidy.

Information on Sources of Health Benefit Coverage for Individuals With Selected Demographic Characteristics

The following tables show percentages of individuals with health benefit coverage in 1989 by selected demographic characteristics (annual income, age, marital status, and race). This information is based on Employee Benefit Research Institute (EBRI) tabulations of March 1990 Current Population Survey (CPS) data. Percentages do not add to 100 because some individuals had health benefit coverage from more than one source during 1989.

Table I.1: Percentage of Workers With Health Benefits, by Total Annual Earnings (1989)

Total earnings	Employer provided	Publicly provided	Privately provided	No health insurance
Less than $10,000	49%	10%	15%	28%
$10,000 - $19,999	73	4	8	17
$20,000 - $29,999	86	3	5	7
$30,000 - $39,999	90	2	6	4
$40,000 - $49,999	90	1	7	3
Over $50,000	88	1	7	3

Table I.2: Percentage of Workers With Health Benefits, by Age (1989)

Age range	Employer provided	Publicly provided	Privately provided	No health insurance
18 to 24	56%	7%	15%	28%
25 to 54	76	5	7	14
55 to 59	77	8	10	9
60 to 64	73	8	14	11

Table I.3: Percentage of Workers With Health Benefits, by Marital Status (1989)

Marital status	Employer provided	Publicly provided	Privately provided	No health insurance
Married	81%	5%	7%	10%
Separated/divorced	64	7	8	22
Never married	59	6	13	24
Widowed	57	9	19	19

Table I.4: Percentage of Workers With Health Benefits, by Race (1989)

Race	Employer provided	Publicly provided	Privately provided	No health insurance
White	76%	5%	10%	12%
Black	65	10	6	23
Other	64	8	10	21
Hispanic	54	5	5	38

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